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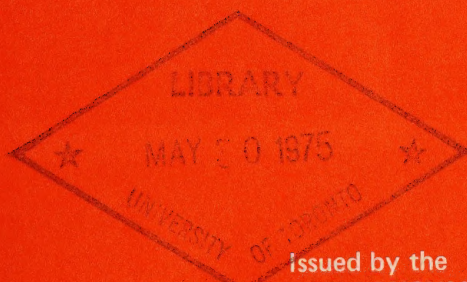


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1975

**REPORT OF THE
INTERMINISTERIAL COMMITTEE
ON COMMODITY FUTURES TRADING**

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MINISTRY OF CONSUMER AND
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February, 1975

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REPORT OF THE
INTERMINISTERIAL COMMITTEE
ON COMMODITY FUTURES TRADING

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MINISTRY OF CONSUMER AND COMMERCIAL RELATIONS

February, 1975



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TO: The Honourable Sidney B. Handleman,
Minister of Consumer and Commercial Relations:

Sir:

We have the honour to submit herewith the Report of the Interministerial Committee on Commodity Futures Trading.

Harry S. Bray

Harry S. Bray, Q.C.,
Ministry of Consumer
and Commercial Relations,
Chairman

David E. Redgrave

David E. Redgrave,
Ministry of Treasury,
Economics and Intergovernmental
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M. Jaeger

Martin J. Jaeger,
Ministry of Agriculture
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Dagmar A. Stafl

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Dr. Thomas P. Mohide

Dr. Thomas P. Mohide,
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Edward F. Then

Edward F. Then,
Ministry of the Attorney General

Barry Tocher

Barry Tocher,
Ministry of Consumer and
Commercial Relations

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P R E F A C E

With the exceptions of Dr. Thomas P. Mohide and Martin J. Jaeger, the remainder of the Committee members approached the study with superficial knowledge of the field. Thanks to the thoroughness and zeal with which our study director, Keith E. Boast, embarked on his task, a series of background and briefing papers were prepared upon which the remainder of the Committee members have based their views. Mr. Boast received the continuing support and assistance of Mr. Jaeger and Robert M. Rickover, an Economist assigned to the study by the Executive Director of the Office of Economic Policy, Ministry of Treasury, Economics and Intergovernmental Affairs, Committee member David E. Redgrave. Edward F. Then, nominated to the Committee from the Ministry of the Attorney-General, undertook an active role during the early stages of the study but found that his other duties precluded this continuing participation. The Committee as a whole met as required to shape, direct and finally to conclude the study through this Report. Dr. Mohide made himself available for consultation throughout the study and brought his considerable expertise to bear through his direction and guidance. In the technical areas, we were also comforted by Mr. Jaeger's knowledge and experience.

This study was not, and is not intended to be, an examination of the economics of commodity futures trading. Standard text books explain the purpose and economic impact of commodity futures trading. All facets of this market place were examined with care in the course of the Congressional hearings which resulted in new and expanded legislation in the United States. Existing trading mechanisms in Ontario and elsewhere in Canada were explored. It was felt appropriate to assess with reasonable urgency the nature and extent of the potential problem in Ontario and, as directed in the Terms of Reference, to recommend a suitable regulatory scheme.

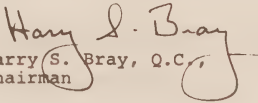
We have attempted to provide a sensible and workable scheme of regulation directed to screening out areas of demonstrated and potential abuse. The legislation, if adopted, will provide a reasonably sophisticated corner-stone capable of being varied and dovetailed as a part of a larger co-ordinated policy directed to the regulation and supervision of financial intermediaries. The impact of commodity trading upon the economy generally and consumer prices specifically was not within our Terms of Reference. We leave the study of these areas to other disciplines.

There are many individuals who with patience and courtesy furnished information, explanations and advice to us. These include the officials of regulatory authorities, commodity exchanges and dealers located in Washington, Chicago, New York, Sacramento, Los Angeles, London (England), and, of course, Winnipeg, Ottawa and Toronto.

Those associations, organizations, firms and other persons from whom we requested direct assistance are listed in Appendix "D". Numbers of the submissions and some of the information obtained were acquired on a confidential basis. We, therefore, determined that we would not append any of it to the report.

Although the material was prepared and assembled under the direction of Mr. Boast, we wish to acknowledge the role of the secretarial staff and, in particular, Ms. Freya Weinberg, who undertook the typing of minutes, memoranda and Report and appendices through its several drafts. Mr. Bray's Secretary, Mrs. Veronica Abreu, also played an active role during the course of the study.

To all of these most important people, with apologies that we were unable to name you all, our sincere thanks.


Harry S. Bray, Q.C.,
Chairman

CHAPTER I

THE BACKGROUND AND SCOPE OF THE STUDY

The Origin of the Study

1.01 Trading in commodity futures contracts and a variety of contracts or agreements based on the present or future price of physical commodities is largely unregulated by any Canadian governmental authority. Securities regulation has existed in Ontario since 1928.^{1/} However, from time to time a particular type of agreement involving a commodity is brought to the attention of a securities administrator who finds it to be a security.^{2/} On the whole, securities administrators have been reluctant to apply the broad definition of "trading"^{3/} in "securities"^{4/} to dealings in contracts involving an option or contract to purchase or sell a commodity in the future. This recognizes the substantial differences between the commodity and capital markets. While there are many appealing similarities, the regulatory tools and techniques designed for the protection of investors in securities are not wholly appropriate for trading in commodity contracts.

1.02 The Minister of Consumer and Commercial Relations, acting on the recommendation of the Ontario Securities Commission, proposed that an

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1. The Security Frauds Prevention Act, S.O. 1928, c. 34.
 2. Rex ex rel. Swain v. Boughner [1948] O.W.N. 141; Regina ex rel. Irwin v. Dalley (1957) 8 D.L.R. (2d) 179; Ontario Securities Commission and Brigadoon Scotch Distributors (Canada) Ltd. [1970] 3 O.R. 714; Farmex Enterprises Incorporated (March, 1974, Ontario Securities Commission Bulletin 50); Pacific Coast Coin Exchange of Canada Limited and Monex International, Ltd. c/o/b Pacific Coast Coin Exchange (November, 1974 Ontario Securities Commission Bulletin 209).
 3. Section 1 (1) 24 The Securities Act, R.S.O. 1970, c. 426, as amended.
 4. Section 1 (1) 22 The Securities Act, R.S.O. 1970, c. 426, as amended.

interministerial study be undertaken utilizing the experience and expertise of ministries with direct interests in the commodity or consumer protection fields. The proposal was accepted and terms of reference established.^{5/} Representatives to the Committee were nominated by the Ministries of the Attorney General, Agriculture and Food, Treasury, Economics and Intergovernmental Affairs, Natural Resources and Consumer and Commercial Relations.^{6/} This Committee held its first meeting on May 28th, 1974.

Regulation in Canada

1.03 Except for the self-regulatory role of Canada's only commodity futures exchange, the century-old Winnipeg Commodity Exchange, over its own members there is no direct regulation. Entry into the field as a futures commission merchant or dealer, an adviser, salesman, or as a commodity futures exchange or coin exchange is unrestricted by specific legislation.^{7/}

1.04 In Ontario those active in the field range from securities dealers and futures commission merchants dealing in futures contracts who are members of or associated with a member of one of the established commodity exchanges^{8/} to self-styled dealers who have no association with an established exchange or its members. Subject only to the criminal sanction of the fraud, "bucketing" or theft sections of the Criminal Code^{9/} the fringe operator may offer contracts for sale with virtual impunity.

5. Terms of reference are set out at Appendix "A".

6. Members of the Committee are listed at Appendix "B".

7. The federal government's proclaimed but as yet unimplemented Grain Futures Act of 1939 S.C. 1939, c. 31, now R.S.C. 1970, c. G-17 by which futures trading in certain grains on the Winnipeg Commodity Exchange would be regulated by the Canadian Grain Commission is discussed in Chapter VII.

8. A trade originating in Ontario would be executed on one of several existing commodity futures exchanges outside Ontario. The exchanges are discussed in Chapter III.

9. Sections 338, 341 and 283 Criminal Code R.S.C. 1970, c. C-34.

1.05 It did not prove possible to accurately determine the extent of the trading in Ontario. Since March 18th, 1974, eighteen members of the Toronto Stock Exchange have reported dealings in commodity futures in the semi-monthly reports required under the Exchange's By-Law 118. Because of competitive factors, information was obtained from dealers on a confidential basis. Even within these parameters the information is not precise. For instance, we were not able to obtain entirely satisfactory information concerning its Ontario trading from the Canadian subsidiary of a U.S. securities firm whose parent maintains all records of commodity futures trading in the United States. It may reasonably be estimated that there are in excess of 10,000 active traders in Ontario.

1.06 Securities dealers holding registration under the Ontario Securities Act and who are members of the Toronto Stock Exchange or the Investment Dealers Association of Canada are subject to minimum capital and other stringent requirements designed to assure their financial viability and ability to service and meet their commitments to their clients.^{10/} These include "know your client" or "suitability" rules. Since trading in commodity futures results in a commitment to purchase or sell the commodity at a future date, it must be considered as part of the firm's capital requirements. The client who trades through a securities dealer is at least the beneficiary of the securities regulatory procedures. As to other dealers their only requirements are those imposed by a commodity exchange of which they may be a member. If they are not members, there are no minimum requirements.

The Need for Regulation

1.07 Trading in commodity futures contracts has proliferated in the United States. Fringe operators have stepped in to take advantage of

10. Section 6, R.R.O. 1970, Reg. 794, as amended.

a speculative climate with resulting frauds. These latter have largely been in options, as distinct from trading in commodity futures contracts. The margin account contracts offered by the self-styled coin exchanges have been very successfully merchandised. The result in the United States has been, after extensive Congressional hearings, the passage of new legislation and the establishment of an independent Commodity Futures Trading Commission.^{11/}

1.08 The Ontario Securities Commission was concerned that persons who were unable to obtain registration in the securities business were free to enter the commodity futures business holding themselves out as dealers or advisers. These fears have proven well founded.^{12/} While the majority of those engaged in the business appear honest in a number of instances they seem inadequately capitalized to service clients and very real questions exist as to their ability to offer advice to the public. In addition, it is not too difficult to anticipate, based upon past experience, that in the face of the extensive and stringent legislation which is to come into force in the United States in April, 1975, those whose business practices are not compatible with that new order may fill the regulatory vacuum now existing here by moving north to establish a base from which they can turn their attention not only to Canadian

11. The nature of commodity futures contracts, commodity options, coin dealers' margin account contracts and the recently extensively amended U.S. federal legislation are dealt with in Chapter II, IV, V and VI respectively.

12. For example, in Regina v. John Vance (Unreported trial before His Honour Judge Honsberger, County Court. Conviction registered September 10, 1974) Vance, the sole principal of Counterpoint Commodity Forecaster Inc., was convicted of defrauding the public of some \$185,000. A former registrant under The Securities Act, who, the Toronto Stock Exchange had ruled should never again be permitted to have any position of any nature with any member firm, Vance purported to be effecting transactions on his clients' behalf when, in fact, he was not placing any orders with any member of a commodity exchange.

residents but south to their former clients and prospects.^{13/}

1.09 Trading in commodity futures contracts and options is an activity for the sophisticated and skilled investor. Nonetheless, it has a fascination for the small speculator. It offers a volatile market whose cost of entry through low margins and relatively low commissions is small. The speculator can leverage his limited capital with the hope of substantial and speedy profits. However, the losses occur as swiftly as the profits. Studies conducted in the United States conclude that the small speculator is most often a loser.^{14/}

1.10 Commodity futures exchanges are of substantial economic importance to both the producers and users of commodities. Through the use of those contracts they are able to lessen their exposure to the financial risks which are the result of the rise or fall in the market price of the particular commodity. Delivery months, contract grade and quantity and other terms are stipulated in the standardized commodity futures contracts. The price is fixed in the auction market of the commodity exchange. The producer or the user of the commodity who attempts to so minimize his risk is termed a hedger.^{15/}

1.11 The hedger and the sophisticated speculator are skilled, active participants in the market place. The trader must have current and accurate information about the commodity traded. Not only must this infor-

13. The notorious naked commodity option, which is discussed infra. Chapter IV para. 4.10 et seq., already has made an initial appearance which resulted in a conviction for fraud of one of the principals, a U.S. citizen, of the firm dealing in them: Regina v. Thomas Boyle (Unreported trial before His Honour Judge Rice, Provincial Court, Criminal Division. Conviction registered September 20, 1974).

14. See, for example, Rockwell, Charles "Normal Backwardation, Forecasting and the Returns to Commodity Futures Traders" Proceedings of a Symposium on Price Effects of Speculation in Organized Commodity Markets Food Research Institute Studies, Supplement to Vol. VIII, Stanford University, Stanford, California, 1967.

15. The commodity futures contract is discussed in Chapter II. The role of the commodity exchanges and their associated clearing houses is reviewed in Chapter III.

mation be completely up-to-date but there must be an immediate capacity to respond as information is received and circumstances change.

1.12 In this market, in the light of the types of contracts being offered and the pitfalls which abound there is an apparent need for those offering their services to the public to be honest, of good reputation, and possessed of some demonstrated competence to provide the service for their clients. This also prompts a consideration of the kinds of contracts offered and the regulatory mechanisms which are applied in various parts of the world. It must lead to a consideration of other basic matters such as minimum financial requirements, record keeping and bonding and insurance.

1.13 Commodity exchanges exist in Canada, the United States, the United Kingdom and elsewhere in the world. Their workings required careful consideration, both the uses and the abuses to which they are put. While Ontario does not have the power to impose regulation on exchanges which are not within its boundaries it would be short-sighted not to consider and provide for the mechanisms through which an exchange could be regulated should the commercial need and a favourable economic environment appear in the future. This part of the study was directed to future need rather than present or immediately anticipated need.

1.14 We have already noted (paras. 1.04 to 1.06) that many of those acting as commodity futures dealers already hold registration under The Securities Act. In addition, other dealers have expanded from other business bases including foreign exchange dealers. The briefs submitted generally favoured some form of regulation for the purpose of establishing standards and eliminating, so far as it is possible through registration, the fraudulent and the incompetent.

The Conduct of the Study

1.15 The principal research was conducted by the Study Director,

Mr. Boast, together with Committee member Jaeger and Robert M. Rickover, the latter having been designated by Committee member Redgrave to assist Mr. Boast. A paper relating to the criminal law was prepared by Committee member ^{16/} Then. H. S. Bray, Q.C., Chairman, played a central role through active participation, guidance and direction. Other committee members participated in meetings and discussions to a lesser extent. The results of the research were circulated with planning and policy meetings being held from time to time at the request of the Chairman.

1.16 The initial stage was to prepare a bibliography, collecting and collating source material. ^{17/} Liaison was established with the appropriate officials at the various provincial, state and federal levels. The securities administrators in each of the Canadian provinces indicated their interest in the Ontario study. The Study Director and some members of the Committee met with officials of the Winnipeg Commodity Exchange, the Canadian Grain Commission, ^{18/} Chicago Board of Trade, the Chicago regional office of the U.S. Department of Agriculture's Commodity Exchange Authority, the California Department of Corporations which administers the California Commodity Law, and in Washington with the Securities and Exchange Commission, the staffs of the House of Representatives and Senate Committees who were dealing with the extensive changes to the Commodity Exchange Act, the Administrator of the Commodity Exchange Authority and his Director of Compliance. In New York the New York Mercantile Exchange and Commodity Exchange Inc. were visited. A meeting was held with the Assistant Deputy Minister, Production and Marketing, federal Department of Agriculture and the Assistant Deputy Minister, Corporate Affairs, federal Department of Consumer and Corporate Affairs together with the Chief Commissioner of the Canadian Grain Commission.

16. See Appendix "E".

17. See Appendix "C" for a short list of recent general materials.

18. This Commission will be responsible for supervising the Winnipeg Commodity Exchange if, as its intention has been announced, the federal government implements the Grain Futures Act of 1939. See Chapter VII.

1.17 With respect to the operation of the commodity futures markets in the United Kingdom, the London Metal Exchange and International Commodities Clearing House Limited, which acts as a clearing house for all the London commodity exchanges except the London Metal Exchange, the London Gold Bullion Market and the London Silver Bullion Market, were contacted. Ontario's Agent General in London, Ward Cornell, and B.W. Gunn, Economic Intelligence Department of the Bank of England, both assisted in facilitating our research.

1.18 An attempt was made to contact all dealers in Ontario and a number were interviewed. The Toronto Stock Exchange and Investment Dealers Association of Canada made available statistics concerning their members' activities in the commodity area.

1.19 Submissions were requested from some fifty-seven associations, organizations, firms and other persons involved in or who appeared to have an interest in the commodity futures market.^{19/} This included not only commodity futures dealers but also agricultural, mineral and other groups having an interest in commodities as producers or users.

1.20 As the research proceeded a considerable body of research material was assembled including not only texts and articles but reports, memoranda, opinions, legislation existing and proposed, the by-laws and regulations of the various commodity exchanges, and a body of case law applicable to the field. This material has been assembled and lodged in the library of the Ministry of Consumer and Commercial Relations.

Outline of the Report

1.21 Although the Committee conducted an in-depth review of the whole field we have striven to present our findings in as simple terms as possible. Indeed, the initiated may at times be impatient at our

19. A list of those from whom briefs were requested indicating those who responded with submissions appears at Appendix "D".

efforts at simplification. Our mandate, however, was not to write a text for those who would speculate or hedge on the futures markets but to assist in informing the judgment of policy makers who may have had no prior acquaintance with the area.

1.22 In Chapter II we consider the commodity futures contract and its attributes. These are traded through a commodity exchange, with the performance normally being guaranteed by that exchange's associated clearing house. The operation of commodity exchanges is discussed in Chapter III. Chapter IV deals with commodity futures options, distinguishing these from the commodity futures contracts dealt with in Chapter II. Coin dealers and their so-called margin accounts have proven very popular, with the resulting concerns leading to a variety of regulatory results in the United States and in Ontario. These contracts are dealt with in Chapter V. The United States federal government, after extensive hearings and legislative debate has enacted comprehensive amendments to the U.S. Commodity Exchange Act which come into force in April, 1975.^{20/} In late 1973 California, in the face of urgent need, passed a Commodity Law, at that time the most articulated commodity futures regulation at the state level. Both of these regulatory schemes are considered in Chapter VI. Chapter VII outlines the history of the federal government's proclaimed but as yet unimplemented Grain Futures Act of 1939. Chapter VIII contains our conclusions and recommends the establishment of a regulatory scheme in Ontario, commencing with the licensing of those permitted to trade in or advise concerning the purchase or sale of commodity futures contracts and options in Ontario, controls as to the types of contracts which can be traded, and a framework of regulation within which a commodity futures exchange could be established and permitted to trade within

20. As a practical matter it now appears that effective transition to the new regime may be somewhat delayed: "New Panel To Oversee Futures Is Lagging In Starting Up; White House Gets Blame", The Wall Street Journal, December 30, 1974 p. 14.

Ontario. We have concluded that with specific additions to the Ontario Securities Commission and its staff the existing organization and regulatory expertise can be utilized without the necessity of establishing a new and distinct Commodities Commission.

CHAPTER II

THE COMMODITY FUTURES CONTRACT

Its Purpose

2.01 As we discuss in Chapter III the principal reason for the existence of commodity futures markets is to enable those who deal in, produce or use the physical commodity to "hedge" - to insulate themselves against adverse changes in price levels. Through the device of the commodity futures contract that risk is transferred to speculators who voluntarily assume it. The speculators back their forecasts as to price movements with their own assets in hope of profit. The accepted opinion is that the abolition of commodity futures markets would require the hedges to maintain greater inventory levels. This would result in increased costs to the ultimate consumer.

Its Features

2.02 A commodity futures contract is an agreement whereby one party buys and the other sells a commodity for delivery in the future. Under it the parties agree to make or take delivery of a specified quantity and quality or grade of a commodity during the designated future delivery month at a price agreed upon when the contract is entered into. It must be distinguished from the "cash" or "spot" contract for immediate delivery of the physical commodity. It must also be distinguished from forward contracts which also call for deferred performance and exchange of title, but which are not usually traded through commodity futures exchanges and whose terms are not so standardized.

2.03 Futures trades are in contracts for later consummation - title does not change hands on execution. Indeed, the commodity to which the contract is directed may not even exist e.g., the farmer's crop may have been planted but not yet harvested. However, unless the contract is otherwise settled, it is binding between the parties and the commodity will be tendered for payment in accordance with the terms stipulated.

2.04 Save for the price negotiated in the "pit" of the exchange,^{1/} the terms and conditions of these standardized contracts are established and set forth in the published by-laws, rules and regulations of the exchange upon which they are traded. The parties only negotiate the price and the number of standardized contracts to be entered. The order is processed through the exchange clearing house which then becomes a party to both sides of the contract, the purchase and the sale.

Settlement

2.05 Only a very small proportion of contracts entered into on a commodity futures exchange are settled by actual delivery. Delivery is normally effected by tendering a warehouse receipt or other evidence of title. Since the exchange clearing house is on both sides of the trade the original seller and purchaser can settle their obligations by purchasing or selling offsetting contracts for a like amount of the particular commodity for the same delivery month. The difference in price between the original contract and the offsetting contract is settled in cash.

2.06 Although something less than 3% of all futures contracts in the United States are settled through actual delivery^{2/} the fact that deliveries are made and taken operates to maintain a general balance between futures and spot commodity prices. Thus most hedgers settle their futures contracts by offset prior to the delivery month and purchase or sell the actual commodity in the spot market.

1. See Chapter III for a description of the operations of commodity futures exchanges.

2. United States House of Representatives, Report on Commodity Futures Trading Commission Act of 1974, 13D Congress 2d Session, p. 129. In contrast, on the Winnipeg Commodity Exchange where speculative participation is lower deliveries have been made on up to 25% of the contracts entered into.

The Elements of the Trade

2.07 The sequence of events, or elements of a trade, is as follows. Firstly, the customer employs a futures commission merchant^{3/} to carry out transactions on his behalf through the exchange. Secondly, the futures commission merchant, through a floor broker,^{4/} contracts with another futures commission merchant through open outcry in the pit of the exchange. Under the rules of the exchange members deal with each other as principals. In the simplest case, where the commission merchant is also a member of the clearing house,^{5/} each submits a report of the transaction to clearing. When the transaction is cleared the clearing house interposes itself dividing the contract in two and becoming the buyer to the selling member and the seller to the buying member. The clearing house views its members as principals and is not bound to recognize any customer of the member. The customer can look only to the futures commission merchant employed by him as agent.

2.08 As between the member and the customer, the customer is entitled, under the contract of agency between them, to have the member undertake any transaction entered into for the customer so long as the customer furnishes the required margin. The customer has the benefit of all profits accruing from such transactions and assumes all losses. The futures commission merchant has the right and, on occasion, where the investment is not a suitable one for the customer, the obligation to refuse an order.

3. A capsule description of the function of the futures commission merchant appears infra. Chapter III, para. 3.25.

4. Infra. Chapter III, para. 3.26.

5. The clearing member's role is discussed in Chapter III, para. 3.27.

2.09 Commodity futures contracts, properly executed on a commodity futures exchange, have been attacked as being illegal and unenforceable because of Section 341, the "bucketing" provision of the Criminal Code, Canada.^{7/} However, it is questionable that Section 341 is intended to apply to the contracts traded, for instance, through the Winnipeg Commodity Exchange. The continuing interest of the federal government in regulating that exchange has not indicated it views the manner in which that business is being conducted as contrary to the public interest in general and the gaming provisions of the Criminal Code in particular.

2.10 It should be noted that "naked options", which are considered in Chapter IV and the operation of some of the so-called coin exchanges which we examine in Chapter V might not be so free from doubt.

Commodity Futures Contracts as "Securities"

2.11 The Ontario Securities Commission made it clear, in proposing this study, that on balance it did not believe the broad definition of "security" contained in the Act it administers (The Securities Act, R.S.O. 1970, c. 426, Section 1 (1) 22) was intended to encompass commodity futures contracts. It did so on the basis that the regulation designed to apply to capital markets, although adaptable in many respects, was not designed to regulate contracts which had as their goal facilitating trading in actual commodities. The commodity futures contract has an important economic function and serves this need through providing the machinery for hedging. A securities type prospectus would not add to the protection of the speculator trading in commodity futures contracts.

6. See Appendix "E".

7. See Beamish v. James Richardson & Sons Ltd. (1914) 49 S.C.R. 595; Maloot v. Bickell & Co. (1920) 59 S.C.R. 429; Prudential Exchange Company, Ltd. v. Edwards [1939] S.C.R. 135.

2.12 Once one moves from the futures contracts to the options and margin accounts considered in Chapter IV and V, the view becomes somewhat different. The burden of opinion among securities administrators appears to be that these contracts are in the nature of investment contracts requiring the issuer of them to file a prospectus demonstrating his ability to perform his part of the contract and describing fully the risks and costs being undertaken by the purchaser.^{8/}

Ontario's Role in World Markets

2.13 In its role as an important source of a number of mineral resources Ontario enjoys a prominent position in world markets.^{9/} Many of the prime producers of these minerals use the commodity futures markets to hedge their production and to determine spot prices.

2.14 Use of the commodity futures markets for these same purposes is, of course, also important to the Ontario producers of certain agricultural products, most notably corn and soybeans.

8. For example, see Pacific Coast Coin Exchange of Canada Limited and Monex International, Ltd. c/o/b Pacific Coast Coin Exchange (November, 1974 Ontario Securities Commission Bulletin 209)

9. World Mineral Production - 1973
(Excluding Cuba, Eastern Europe, U.S.S.R. and China)

Mineral Commodity	Ontario % of Free World Mine Production	Ontario % of Canadian Mine Production	Canada % of Free World Mine Production	Canada's Rank in Free World
Nickel	36.1%	71.6%	49.5%	1
Zinc	8.4%	33.8%	27.0%	1
Silver	8.0%	41.3%	19.3%	1
Copper	4.2%	31.6%	13.5%	2
Gold	2.5%	47.2%	5.4%	2
Platinum Group*	21.2%	99.1%	21.4%	2
Uranium	16.5%	85.3%	19.4%	2
Cobalt	5.8%	79.2%	9.0%	3
Cadmium	9.7%	65.9%	14.4%	4

* 1972 data

Sources: Statistics Canada
Roskill Information Services
American Bureau of Metal Statistics
Handy & Harman

CHAPTER III

COMMODITY FUTURES TRADING AND ITS ECONOMIC FUNCTION

A. COMMODITY EXCHANGES AND CLEARING HOUSES

In General:

3.01 Commodity futures exchanges, which may be incorporated or unincorporated, are created to provide an orderly forum for trading in commodity futures contracts. The exchanges frequently provide facilities for cash or spot transactions as well. The organization, through its by-laws and regulations, establishes the rules and conditions under which trading must be conducted and conditions for membership.

3.02 The exchanges in North America do not own commodities nor do they trade in commodity futures contracts for their own account, though the exchange clearing house does inject itself into trading in the manner described supra. Chapter II, para. 2.07 becoming, between its members, the buyer to each seller and the seller to each buyer. The principal functions of North American exchanges are to provide the physical facilities necessary for an open auction market, to establish and enforce the rules of trading, fix the terms and conditions for commodity futures contracts permitted to be traded on their floors, record and transmit details of transactions to members and the public, provide information and communications for members, establish rules and conditions of membership, provide the mechanism for the arbitration and settlement of trading disputes between members, and the machinery for the investigation of complaints and the enforcement of their rules including sanctions against members.

Membership: Who and Why

3.03 Exchanges are established to fulfill an economic need. This is illustrated by examining their membership. For instance, the members of the Winnipeg Commodity Exchange include country elevator companies and co-operatives, the Canadian Wheat Board, grain terminal elevators, shippers, exporters, crushers, mulsters, millers, feed manufacturers, feed lot operators, packers, bullion dealers, banks, insurance companies, lake carriers, foreign buyers, cash and futures brokers as well as commission merchants or dealers.^{1/}

3.04 There are several reasons for owning a seat on a commodity exchange. There is the incentive of lower commission rates for members. In addition, membership does give a right of access to the trading pit where there is a constant flow of the information upon which price discovery depends. This gives a substantial advantage to the member.

Floor Trading: Publication of Trading

3.05 The bidders meet during the prescribed hours in the pits or trading rings in which the auction is conducted. The bids and offers must be made by open outcry. However the resulting din is such that market floor brokers communicate frequently through standardized hand signals.

3.06 Since this is a professional market, the techniques do not seem to be so well delineated as on the stock exchanges to assure that the public client gets the best execution and fill. On North American exchanges priorities are established by time stamp and price. An observer reports the transactions so that they are immediately published on a blackboard or electronic display system. Prices are made public continuously through transmission over a ticker system and the wire services.

1. The Winnipeg Commodity Exchange, Origin and Development, Winnipeg Commodity Exchange, Winnipeg, Manitoba, June 1974.

The floor trader records the executed transactions on a card which is the first stage of the clearing process described below. The executed trade is reported back by the floor clerk to his office. The salesman then reports to his customer.

The Clearing House

3.07 North American commodity exchanges have an affiliated clearing house, usually a separate corporation. Its shareholder members are limited to those members of the commodity exchange who can meet its financial requirements. In addition to becoming a shareholder the deposit of a substantial amount of money in the clearing house's guarantee fund ^{2/} may be necessary.

3.08 All transactions in commodity futures contracts on the North American exchanges are cleared through their clearing houses. The clearing members are permitted to deal with the clearing house directly while all other exchange members must clear through a clearing member of their selection. The traders' cards are forwarded to the clearing house and balanced. If there is a discrepancy notice is sent to the clearing members involved and if the difference cannot be reconciled the trade is rejected by the clearing house and the dispute goes to arbitration. Each day's trading is balanced before the next day's trading begins.

3.09 Once the process of reconciliation is completed the clearing house assumes, between its members, both the legal and financial obligations of seller to all buyers and of buyer to all sellers. It guarantees

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2. In London, England an independent company, the International Commodities Clearing House Corporation Limited (ICCH), performs the the clearing function for all commodity exchanges except the London Metal Exchange, the London Gold Bullion Market and the London Silver Bullion Market. Membership in the ICCH is not confined to exchange members but is open to individuals and companies resident in the United Kingdom and Overseas.

The Winnipeg Commodity Clearing, Ltd., the clearing house for the Winnipeg Commodity Exchange does not require a guarantee deposit.

the integrity of all exchange transactions. It also pays out and receives on a daily basis the net daily gain or net daily loss of each clearing member on his transactions.

Standing and Variation Margins

3.10 Each clearing member is required to have on deposit with the clearing house sufficient money, known as standing margin, to provide a cushion which will ensure his ability to meet his obligations under the contracts to which he is a party. Standing margins are determined by the clearing house's governing body and vary depending on such factors as the value of the commodity represented by the contract and its price volatility. It is calculated daily after netting the contracts bought and sold. The appropriate margin rates are applied to the resulting position and the aggregate standing margin for the day is calculated. When additional margin is required it must be posted before the opening of the next day's trading.

3.11 Standing margins are designed to cover daily maximum price fluctuations. If the market prices move against the clearing member's position, thus impairing his standing margin to the extent of such changes, the clearing house may make a special demand known as a variation margin call which must be met, generally, within one hour of the call.

3.12 These demands, of course, are passed on from the clearing member to the futures commission merchant to the customer. In the end result the customer is responsible for furnishing the money to properly margin his contracts.

Original and Maintenance Margins

3.13 Distinct from the standing and variation margins which we have just discussed are the mandatory minimum margin requirements which the commodity exchange, as opposed to the clearing house, may require

their members exact from those for whom the exchange members act. Original margin is the initial deposit required, the earnest money when the contract is entered into. Maintenance margin is the amount required in addition to the original margin when the commodity contract price moves against the customer's position.

Purpose of Margin

3.14 The primary function of margin is to ensure performance under the contract which in turn protects the solvency of the commission firms. The exchanges seek to fix margin levels high enough to achieve this purpose without discouraging speculative participation and thus reducing the market's liquidity.

The Difference From Margin in a Securities Transaction

3.15 In a securities transaction the margin represents a down payment on the stock. The broker who purchased the stock for the client extends the client a line of credit keeping the securities as collateral for the loan. In a commodity futures transaction the purchase is not immediately completed. Final settlement is not due until delivery. The margin is earnest money demonstrating an ability to meet the obligation when it comes due.

Delivery

3.16 When the seller intends to deliver the commodity against cash when a commodity futures contract becomes due he serves notice of intention upon the clearing house through his clearing member, the length of notice required varying up to eight days depending on the particular commodity and the rules of the exchange. The general practice of the clearing house is to pass it to the clearing member who,

- (a) has the oldest open long position in the commodity;

(b) has the largest net long position, or

(c) has the largest gross open long position.

The clearing member will then pass it on to the non-clearing member or customer having the oldest, the largest net long position or the largest gross open long position as the case may be. Open positions are those that have not been liquidated through offsetting contracts or delivery.

3.17 Once he has determined who will fulfill the obligation the clearing member notifies the clearing house. The clearing house, depending on the practice of the exchange, may leave the buyer and seller to complete the transaction through direct dealing in accordance with the terms of the contract or may act as an intermediary in the exchange of documents of title and cheques.

B. PARTICIPANTS IN THE MARKET PLACE

The Hedger

3.18 The commodity futures market is of prime importance to the hedger. His business involves dealing in, producing or using the physical commodity. By hedging through the commodity futures market he has an opportunity of transferring the risk of adverse price movements in the cash commodity to others. To the futures commission merchant he is a trade account. Hedgers are often members of the commodity exchange.

3.19 The hedger relies on the prevailing tendency of the cash and futures prices of the commodity to roughly come together in the futures delivery month. The hedger, taking an equal but opposite position in the futures market, intends to offset what happens in the cash market by what happens in the futures market. A loss in cash will mean a gain in futures and vice versa. The producer may go short or sell a futures contract today to eliminate or reduce any loss he might suffer through a decline in

the cash market when the time comes to sell his product. A processor seeks to lessen the loss from a possible advance in price of the commodities he must purchase at some time in the future.

Speculators

3.20 While the futures market serves the economic needs of the hedger, at any instant in time there may not be sufficient buying hedges to offset selling hedges or sufficient selling hedges to take up the buying hedges.^{3/} It is the speculators, prompted by the opportunity for profit, who voluntarily assume the risk that the hedgers are unwilling to bear. The majority of experts declare that the speculator is necessary for the continuity and liquidity of the futures market. It is the speculator who absorbs the hedgers' orders with a minimum of price disruption. The speculator is said to assist in minimizing price fluctuations rather than exaggerating them.

3.21 We will not dwell on the distinction between the gambler and the speculator. Certainly the speculator has no cash commodity requirements but purchases and sells futures contracts in the hope of benefitting from the price movement of the contract itself. Because he serves a useful economic function the speculator acquires a commercial status at least.^{4/}

3.22 The ranks of speculators include skilled professionals knowledgeable and well informed. They may be exchange members trading for their own accounts in the pit. Of these some are known as "scalpers" or "day traders" who strive to make short-swing profits through offsetting

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3. Report of the Royal Grain Inquiry Commission (1938), King's Printer, Ottawa, p. 45.
4. See Holmes, J., Board of Trade of Chicago v. Christie Grain and Stock Co. 198 U.S. 236 at 247 quoted by Duff, J., in Beamish v. James Richardson & Sons Ltd. (1914) 49 S.C.R. 595 at 616. Also see Baer, Julius B. and Saxon, Olin G., Commodity Exchanges and Futures Trading, Harper and Brothers, New York, 1949, p.63.

trades, flattening or settling all accounts on the same day. Other professional speculators may take positions for more extended periods.

2.23 It is to the position of the unsophisticated and under-capitalized speculator that our attention must be primarily directed. In a volatile market, enticed by minimal margins, the lure of leverage, and the relatively low "round trip" commissions^{5/} he is extremely vulnerable. A relatively small change in the price per unit of the commodity can result in a significant change in the value of the commodity futures contract. This in turn will lead to a call for added maintenance margin. Moreover, when the changes are dramatic, and the market is making "limit moves"^{6/} several days in succession the speculator may find it impossible to extricate himself without substantial losses.

3.24 A study covering twenty-five commodity futures markets in the United States during the period 1947-1965 indicated that small speculators tended to suffer net losses while large speculators tended to make net profits.^{7/} It has been suggested that such figures indicate that hedgers are also using their access to up-to-date information and their forecasting skills to advantage in speculation.^{8/}

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5. There is only one commission charge and that entitles the client a "round trip", a purchase and sale or vice versa.

To trade a 100-ounce gold futures contract on the Winnipeg Commodity Exchange valued at U.S. \$175.00 an oz. or U.S. \$17,500.00 the commission charge is U.S. \$35.00 or 0.2% of the value of the contract. to trade a 1,000 bushel flaxseed futures contract valued at \$8.00 a bushel or \$8,000 the commission charge is \$5.50 or 0.069% of the value of the contract.

6. Commodity futures exchanges establish maximum daily permissible price changes in each commodity - certain amounts above or below the previous day's closing price beyond which limits no trades may be effected. The rationale of such limits is to prevent a panic snowball and encourage traders to a sober and objective analysis. However, several days may elapse before a contract is concluded. The net loss or gain can be substantial before a trading level is found.
7. Supra. Chapter I, footnote 14.
8. "The Dangerous Bull in the Commodity Markets", Fortune Magazine July, 1973, 65 at p. 70.

The Futures Commission Merchants

3.25 The futures commission merchants are the equivalent to stock brokers in the securities market. Indeed, the largest futures commission merchants are the integrated securities firms. They act very much as do stock brokers, reviewing the needs of clients, advising, accepting clients' orders, striving through floor traders to provide the best execution possible, guaranteeing clients' accounts to the clearing house, making and taking delivery, collecting and paying money, acting as custodian of clients' funds, maintaining and rendering accounts to clients which set out the open position, margin deposits, completed transactions, profits, losses and the current balance. They are subject to regulation in the United States.^{9/}

The Floor Broker

3.26 The floor broker executes trades as agent or employee for futures commission merchants or his customers. At the same time he may be free to trade for his own account as principal.

The Clearing Member

3.27 The special role of the clearing member was discussed in connection with the commodity exchanges and clearing houses, paragraphs 3.01-3.15

9. Infra. Chapter VI, para. 6.22 et seq.

C. THE ECONOMIC FUNCTIONS OF
COMMODITY FUTURES TRADING

Benefits of Hedging

3.28 The principal reason given for the existence of commodity futures markets is that they enable those who deal in, produce or use the cash commodity to hedge - that is, to insulate themselves against adverse changes in price levels. The risk is transferred to those prepared to accept it and the hedger's profit margins protected. Consequently, the hedger probably will have easier access to bank loans and other financing at, possibly, a lower rate of interest than otherwise. This is of particular importance to smaller firms with limited amounts of internally generated funds who are thus better able to obtain the money needed to operate and to compete with large companies not so dependent on outside financing.

3.29 That participants in the cash commodity markets can so reduce borrowing costs by hedging in the commodity futures markets should result in lower prices for their output, assuming competitive conditions. The likelihood of competitive conditions is enhanced by the particular benefit hedging affords smaller firms.

As a Stabilizing Influence

3.30 Commodity futures trading still is credited with the role ascribed to it by the Royal Grain Inquiry Commission in 1925, that of bringing the demand for the cash commodity in line with the supply. ^{10/}

10. Report of the Royal Grain Inquiry Commission (1925) King's Printer, Ottawa, p. 133. See United States House of Representatives, Report on Commodity Futures Trading Commission Act of 1974, 93D Congress 2d Session, p. 132.

That Commission's report, at page 133, states:

"In its broadest economic aspect speculative trading by calling attention, at the earliest moment that information develops, to changing conditions of supply or demand, warns society that it is on the eve of a period of greater scarcity. The knowledge of a large or short harvest begins to exert its effect on prices some time before the grain is actually garnered. A fall in prices thus gives notice that a more lavish use of grain and its products is possible. An early rise checks consumption and leads to a conservation of the supply throughout the period of scarcity. The general effect of these reactions by society to high or low prices is to stabilize the amplitude of the fluctuation in prices. Speculation thus exercises a stabilizing influence."

The speculator, utilizing to his profit a superior forecasting ability, purportedly assists in the rationing and allocation of resources.

3.31 Price fluctuations are said to be further dampened as a result of the continuous dissemination of information, including price quotations, by the commodity exchanges which, in turn, aids to dispel the ignorance of market conditions that promotes erratic price behaviour.

3.32 The conclusion that speculation aids stabilization is not universally held. Various representatives of the farmers of Western Canada forcefully offered contrary views to a series of federal Royal Commissions into the grain trade conducted in the 1920's and 1930's, as, for example, the opinion of the Pool organizations of Alberta, Saskatchewan and Manitoba quoted at page 39 of the 1938 report: ^{11/}

"We are satisfied that the futures market does cause fluctuations not justified by the supply and demand for wheat, and this fluctuating price does not necessarily reflect work value. Indeed it would appear to be true to say that the futures market is not a system of intelligent merchandising; it is merely an example of irresponsible mob blundering. This tendency towards instability in price, which many farmers are convinced is aggravated by speculation, is one of the most serious indictments numerous farmers level against the futures market."

11. Report of the Royal Grain Inquiry Commission (1938), King's Printer, Ottawa.

3.33 The argument continues in Canada. Recently, certain initiatives of the federal government,^{12/} the purposes of which are of no direct concern to this Committee, rekindled the debate over the social and economic utility of the commodity futures market between the proponents of an open market system and those who favour the concept of the marketing board.^{13/}

3.34 Some consumer advocates suspect that in recent years speculation has forced commodity futures to artificially high levels which in turn are reflected through the cash market in higher prices to the consumer.^{14/} In response to such charges spokesmen for the futures markets have asserted that fundamental supply and demand factors have been the major force behind the overall increase in commodity prices.^{15/}

3.35 The subject of fluctuations was exhaustively discussed by the 1931 Royal Commission on Trading in Grain Futures with its conclusions being endorsed and summarized in the Report of the Royal Grain Inquiry Commission (1938). This latter report states, at page 53:

"...fluctuations are divided into three classes:

- (1) long period major trends of price wherein grain is related to all other commodities;
- (2) major fluctuations in price extending from year to year and from quarter to quarter;
- (3) minor short period (daily and hourly) oscillations running round about the major fluctuations of class (2).

The report finds as to class (1) that futures trading has no effect on them; as to class (2) that it lessens them, helps stability and thereby makes the producer's

12. See infra. Chapter VII, paras. 7.15, 7.16 and 7.17.

13. See, for example, "Our Daily Bread" Macleans Magazine, September 1974, p. 72b.

14. See Stewart, Walter, Hard to Swallow, Macmillan Company of Canada Ltd. Toronto, 1974.

15. See, for example, Food Prices and Futures Markets, Chicago Board of Trade, Chicago, 1974. Also see "Futures Buying Not A 'Rip-off' Economist Says" Toronto Daily Star October 22, 1974, p. A3.

position more stable and secure; as to class (3), that it probably increases them, but that whatever disadvantages these oscillations may produce is less than the advantages produced by the fluctuations of class (2)."

3.36 The short term oscillations are not peculiar to the commodity futures markets but are found in all freely operating markets such as those in stocks, foreign exchange and short and long term indebtedness. These sudden changes reflect the fact that price determination is a continuing process. Each new piece of information, substantial or baseless, is immediately digested by the market, assessed, and may be reflected in a new price. There is no reason to conclude that a market dealing in commodity futures is any more susceptible to uninformed speculation than other markets. Indeed, it is argued that because commodity futures contracts are commitments to make or take delivery of the cash commodity, the nexus between the "paper", the commodity futures contract, and actual economic activity is more concrete than that obtaining, for example, in the sometimes abstract speculation which occurs in trading in shares of public companies.

3.37 However, responses to our requests for briefs, indicate that the producers, at least, have the kind of general concerns voiced by the Royal Grain Inquiry Commission of 1938 which stated, at pages 52-53 of its report:

"Speaking generally of manipulative practices, the belief is expressed by those who speak for the Winnipeg Grain Exchange that if they exist here at all it must be on a much smaller scale than in the United States. But the means of obtaining reasonably conclusive evidence on the question, one way or the other, still does not exist. On this point I find myself back again to the position expressed by the Stamp Commission of 1931, where the following statement is made at page 60 of their report:

'There is no doubt whatever that a feeling is prevalent amongst many farmers that someone is making money at their expense unfairly by inside knowledge, manipulation and undesirable practices. Nothing was given in evidence of a practical or satisfactory character as to what it

actually is that is done or how it is done, and in that respect we share the experience of the Turgeon Commission.

But we cannot claim to have been able to satisfy ourselves conclusively as to the impossibility of such practices existing."

3.38 Apart from instances of fraud and manipulative practices, markets are a mirror of economic realities. In the United States, for instance, transportation bottlenecks, shortages of warehouse space and the impact of various government policies may be directly reflected in price movements on the commodity exchanges.^{16/} Price behaviour on the Canadian futures markets is affected similarly by congestion in transportation and warehousing and the actions of government.

16. To minimize the effect of the two former factors the new U.S. federal legislation gives to the regulatory authority the power to designate delivery points in addition to those specified in the contracts drawn up by the commodity exchanges. Infra. Chapter VI, para.6.16.

CHAPTER IV

COMMODITY FUTURES OPTIONS AND COMMODITY OPTIONS

Commodity Futures Contracts and Commodity Futures Options Distinguished

4.01 In Chapter II we examined the commodity futures contract and found it to be a contract for the purchase and sale of a specified quantity and quality of a commodity deliverable at a specified future time. A commodity futures option is an option to purchase from or sell to the grantor of the option an underlying commodity futures contract at a fixed price termed the "striking price"^{1/} within a certain period running from the purchase date to the "declaration date" at which latter time the right expires.

4.02 In consideration for this right the option grantor collects a charge called the "premium" which represents the full extent of the purchaser's financial commitment up to the time the option expires or is exercised. Unlike the holder of the commodity futures contract, the option holder is not subject to any original or maintenance margin calls during the life of the option.

4.03 The purchaser who obtains an option to sell an underlying commodity futures contract to the option grantor has obtained a "put". If he purchases an option to obtain a commodity futures contract he has bought a "call". In some markets, he may obtain a "double option" from the option grantor which gives him the right to either buy or sell the underlying commodity futures contract but not both.

4.04 The purchaser of a call realizes a profit if the price of the

1. The striking price is an agreed price based on the market price for the underlying commodity futures contract on the day the option is written.

underlying commodity futures contract rises. He then exercises his option by notifying the option grantor and becomes, at the agreed striking price, the holder of a long position in the underlying commodity futures contract on the particular commodity exchange on which the contract is traded. In the case of a put, the option purchaser profits if the price of the underlying commodity futures contract falls. On exercise the purchaser of a put becomes, at the striking price, the holder of a short position in the underlying commodity futures contract. If the person who has exercised his option and assumed a long or short position in the commodity futures contract does not immediately liquidate his position by an offsetting contract ^{2/} on the exchange he becomes subject to the usual margin requirements. ^{3/} His profit is the difference between the striking price and the price at which he liquidates his position in the commodity futures contract less the premium paid to the option grantor and commission costs on liquidation.

London Commodity Futures Options

4.05 In London, England, commodity futures options are traded only on commodity exchanges. As with the commodity futures contract in North America the bids and offers are made by open outcry on the floor of the exchanges so that the levels of the premiums are determined competitively. ^{4/}

4.06 In addition to the cost of the premium the option buyer pays a commission to the exchange member through whom he purchases the commodity futures option both at the time the option is granted and when it is

2. Supra. Chapter II, para. 2.05.

3. Supra. Chapter III, para. 3.13.

4. The premium is governed by the length of time the option has to run and the degree of activity in the market; the longer the time or the more volatile the market the higher the premium. In general, the premium fluctuates at between 5% and 15% of the market value of the futures contract at the time of the grant.

exercised.^{5/}

The Role of the International Commodities Clearing
House Limited (ICCH) as Guarantor

4.07 Commodity futures options traded on the various London "terminal markets" or commodity exchanges, other than the London Metal Exchange, the London Gold Bullion Market and the London Silver Bullion Market are cleared and guaranteed by ICCH. The option purchaser deposits the full premium with ICCH. ICCH retains the premium on behalf of the grantor, paying an appropriate rate of interest, until the commodity futures option to which it applies has been exercised or abandoned. The premium funds are available then to satisfy the grantor's obligations to the option buyer. The grantor must also put up original margin, returnable on the option's exercise or abandonment. When the price moves against the grantor it must meet maintenance margin calls. Both original margin and maintenance margin are calculated in the same way as for normal commodity futures contracts. The grantor is frequently a major dealer in the physical or "soft" (non-metal) commodity.^{6/}

London Metal Exchange Commodity Futures Options

4.08 The London Metal Exchange is primarily a principals' market. Its members are normally substantial dealers in the physical commodity as well as in futures contracts. The exchange also has facilities for trading in commodity futures options granted by its members as principals but

5. One half of the commission is paid upon the grant of the option and one half upon the exercise and liquidation for a total of one "round trip" futures commission.

6. For further details see A Guide to ICCH Regulations, Documentation and Examples of Option Contracts, International Commodities Clearing House Limited, London, 1974.

these options are not guaranteed by any clearing house.^{7/}

Winnipeg Commodity Exchange Commodity Futures Options

4.09 In 1931 the Winnipeg Grain Exchange, now the Winnipeg Commodity Exchange, created a formal market for the purchase and sale of one-day options on grain futures.^{8/} They could trade for only one half an hour after the close of the regular market. Members were forbidden to deal in them at any other time. The price of the option was \$1.00 per 1,000 bushels. The options were conceived as insurance against price fluctuations overnight, bridging the gap so as to ease the differences in price from one day's trading to another.

4.10 A relatively inactive option market still exists, expanded to include oilseeds. The options may be from overnight to fourteen days but can still only be traded during the half hour following the close of the regular market. The consideration remains at \$1.00 per 1,000 bushels for inter-day options. It is \$1.25 per 1,000 bushels for weekly options.^{9/} The function of these options is still conceived as providing price protection on inter-session risks for the trade.^{10/}

4.11 The commodity futures options traded on the Winnipeg Commodity Exchange, unlike commodity futures contracts traded on that Exchange, are not cleared and guaranteed by the Exchange's clearing house.

7. However, the London Metal Exchange is reported to be entertaining plans to introduce a clearing system: American Metals Market, June 6, 1974.

8. Report of the Commission to Enquire into Trading in Grain Futures (1931), King's Printer, Ottawa, pp. 32-33.

9. By-Law #26, "Options Trading" Regulations, May 8, 1974, p. 48, Winnipeg Commodity Exchange.

10. Ennis, R.S., President, Winnipeg Commodity Exchange, Letter to Commodity Futures Study Committee Chairman dated September 25, 1974.

"Naked" Commodity Futures Options

4.12 Though there are varying interpretations given to the term it can be said that the "naked" commodity futures option represents nothing more than the option grantor's unsupported promise to perform. The option grantor does not necessarily own commodity futures contracts or the physical commodity to meet his obligation nor is performance of the obligation guaranteed by a recognized exchange or clearing house.

4.13 Recent popular use of the term arose out of the checkered history of trading in commodity futures options in the United States. In 1921 the Chicago Board of Trade recommended that trading in options be prohibited, and, the same year the United States passed the Futures Trading Act which through the levy of a twenty-cent per bushel tax effectively prohibited options in grains. This Act was declared unconstitutional in 1926 and option trading resumed. A sensational price collapse in grain futures markets in the summer of 1933 led the Board of Trade to suspend all trading in options asserting that the elimination of such trading removed a prime cause of excessive price movements. The U.S. federal Commodity Exchange Act of 1936 made all trading in commodity futures options in the commodities regulated by that Act illegal.^{11/} However, trading in options on commodities not regulated under that Act, the so-called international or world commodities such as cocoa, copper, palladium, silver and sugar was not affected by the ban.^{12/}

4.14 In 1971, during which year the most volatile commodity futures markets in recent history developed, a significant market in options on unregulated commodities emerged in the United States. The pioneer in what was an aggressively promoted, successful, high-pressure sales campaign

11. Section 4c(B) U.S. Commodity Exchange Act. For a list of the "regulated" commodities see Chapter VI, footnote 7.

12. Examples of "unregulated" commodities are listed in Chapter VI at footnote 8.

directed at the unsophisticated small investor was the now infamous California-based firm of Goldstein, Samuelson, Inc. Using the form and terminology of the conventional commodity futures option market these firms followed the familiar "Ponzi" pattern^{13/} representing that their liabilities were covered through the purchase of commodity futures contracts, encouraging the "successful" investors to leverage their profits by "reinvesting" in additional options or paying them off from the premiums paid in by new investors. The falsity of these assertions quickly became apparent in the bankruptcies which followed.

4.15 The naked option grantor's ability to meet his obligations depends on his assets, his ability to generate premium income through the sale of additional options, and his success in investing revenue and managing the enterprise including speculation in the commodity futures

13. The "Ponzi scheme" was described by Chief Justice Taft in Cunningham Trustee of Ponzi v. Brown, 265 U.S. (1924)1:

"The litigation grows out of the remarkable criminal financial career of Charles Ponzi. In December 1919, with a capital of \$150, he began the business of borrowing money on his promissory notes. He did not profess to receive money for investment for account of the lender. He borrowed the money on his credit only. He spread the false tale that on his account he was engaged in buying international postal coupons in foreign countries and selling them in other countries at 100 percent profit, and that this was made possible by the excessive differences in the rates of exchange following the war. He was willing, he said, to give others the opportunity to share with this profit. By a written promise in 90 days to pay them \$150 for every \$100 loaned, he induced thousands to lend him. He stimulated their avidity by paying his 90-day notes in full at the end of 45 days at 100%. With the 50 percent promised to lenders, every loan paid in full with the profit would cost him 60 percent. He was always insolvent, and became daily more so, the more his business succeeded. He made no investments of any kind, so that all the money he had at any time was solely the result of loans by his dupes."

market for his own account.^{14/}

4.16 In their dealings the naked option grantors or sellers rarely contemplated the exchange of the underlying commodity futures contract. The firms offered to "repurchase" the option crediting the option holder with the difference between the striking price and the current market value of the underlying commodity futures contract.^{15/}

Securities Laws and Commodity Futures Options

4.17 In the wake of the collapse of a number of option firms and consequent considerable financial losses suffered by the public a number of states, led by California, banned the further sale of commodity futures options until they were registered as securities.^{16/} (California subsequently elected to regulate commodity futures options under its Commodity Law brought into force on an emergency basis on September 25th, 1973).

14. Goldstein, Samuelson, Inc. was founded on April 28th, 1971, with the initial and only capital contribution being \$800.00. According to the U.S. federal Securities and Exchange Commission brief, pages 8, 10, in S.E.C. v. Goldstein, Samuelson, Inc. Civ. A. No. 73-472 (C.D. Cal., October 11th, 1973) up to February 27th, 1973, the company received some \$88,000,000.00 from about 13,000 customers for approximately 195,000 options on unregulated commodities. Another California firm, Puts and Calls, Inc., between April 1st, 1972 and February, 1973, with a paid in capital of \$1,000.00 obtained premiums of \$15,335,781.00 according to the Plaintiff's Trial Memorandum of Fact and Law, page 9, in People of California v. Puts and Calls, Inc. Civ. No. C-51071, (Cal. Super. Ct., Los Angeles County, Dept. 51, filed August 6th, 1973).
15. Since the features of the naked option indicate a lack of bona fide intention to make or take delivery of the underlying commodity futures contract the question is raised whether such trading constitutes gaming on the rise or fall in the price of "goods, wares or merchandise" in contravention of Section 341, the "bucketing" provision of the Criminal Code, Canada. See Appendix "E".
16. In 1973 and 1974 action was taken in California, Oregon, Washington, Colorado, Pennsylvania, Utah, Georgia, Indiana, Michigan, South Dakota, Arkansas, Texas, Maryland, Oklahoma, and Nevada as well as by the federal U.S. Securities and Exchange Commission. In Ontario the naked commodity futures option made an appearance in early 1974 which resulted in a conviction for fraud of one of the principals of the firm dealing in them: Regina v. Thomas Boyle (Unreported trial before His Honour Judge Rice, Provincial Court, Criminal Division. Conviction registered September 20, 1974)

Generally, the naked commodity futures options have been found to be securities by reason of being investment contracts.^{17/}

4.18 Turning to the commodity futures options traded on the London commodity exchanges, both those guaranteed by the ICCH and those traded, without any third party guarantee, on the London Metal Exchange and to the commodity futures options traded, without clearing house guarantee, on the Winnipeg Commodity Exchange they, too, may be investment contracts according to the previously noted widely-held opinion among securities administrators.^{18/}

4.19 It may also be open to a court to find commodity futures options fall within the wide-ranging definition of security under head ii of Section 1(1)22 of The Securities Act (Ontario). Following the reasoning of Hart J., in Ontario Securities Commission and Brigadoon Scotch Distributors (Canada) Ltd.^{19/} the test appears to be the essential nature of the transaction, that is whether the parties intend to deal in pieces of paper or in physical commodities.

4.20 In reaching a conclusion it may be that the test proposed by the Ontario Securities Commission in Pacific Coast Coin Exchange of Canada Ltd. c/o/b Pacific Coast Coin Exchange^{20/} based on the need of the investor for protection recommends itself. There the Commission found that prospectus disclosure concerning the issuer (or option grantor in commodity futures option terms), was essential so that firstly the Commission might determine whether the issuer had the capacity to meet the obligations it was undertaking and secondly, if so, whether the investor clearly understood the nature of the arrangement and the risks he is being asked to

17. See Section 1(1)22xiii The Securities Act, R.S.O. 1970, c.426, as amended.

18. Supra. Chapter II, para. 2.12.

19. [1970] 3 O.R. 714.

20. November 1974, Ontario Securities Commission Bulletin 209.

undertake.

Economic Utility of Commodity Futures Options

4.21 Commodity futures options are more attractive than commodity futures contracts to some hedgers because of the absence of margin calls during the life of the option. Other hedgers prefer hedging through options rather than commodity futures contracts directly because of the unpredictability of their requirements for the particular commodity. An option grantor who deals in, produces or uses the physical commodity can reduce fluctuations in income while at the same time generating premium income.

4.22 Opponents of commodity futures options argue that they reduce the liquidity of markets in commodity futures contracts by taking business away, one critic stating, however:

"...[the] less well-informed and less well-capitalized traders, ... contribute little to improved futures market performance and little to the incomes of brokerage firms." 21/

Moreover, rather than exerting a stabilizing effect through increasing liquidity, some critics suggest the hedging activities option grantors may undertake to meet their obligations have an inherent bias toward exaggerating price movements on the commodity futures markets. The option grantor may cover futures contracts only when the market has moved a certain amount in favour of the option holder. If he hedges long after prices have moved up and short after prices have started down he will exacerbate

21. U.S. Department of Agriculture, Commodity Exchange Authority, Meeting on Trading in Puts and Calls in Non-Regulated Commodities, February 14, 1973, Washington, D.C. Statement of Professor Roger Gray, Stanford University.

the upwards or downwards spiral.^{22/}

Commodity Options: Metal Dealers' Options

4.23 Before leaving the subject of options we should point out that there are a number of international metal and bullion concerns who offer to speculators options on the actual commodity^{23/} as opposed to the options we have discussed to this point which have a commodity futures contract as the underlying subject matter of the option. These options are purportedly backed by the firms' own inventories.

22. Trading in commodity futures options on commodities presently regulated under the U.S. federal Commodity Exchange Act is banned and will continue to be proscribed under the recent amendments. With respect to commodities being brought under the Act for the first time trading in options will be permitted if not contrary to any regulations promulgated by the newly established independent agency responsible for overseeing commodity futures trading, the Commodity Futures Trading Commission, within one year of the effective date of the amendments, and under such terms and conditions which may vary by markets, as the Commission may prescribe. See infra. Chapter VI, para. 6.08.

23. The best known are those offered by Mocatta Metals Corporation one of the largest precious metals dealers in the United States.

CHAPTER V

THE COIN DEALERS AND MARGIN ACCOUNT CONTRACTS

The Origin of the Margin Account Contract

5.01 In 1965 the United States adopted cupro-nickel clad copper coins instead of silver coins. Four years later it became legal for U.S. residents to melt silver coins for their content. Silver coins minted before 1965 went to a premium over their face value as spot price for silver rose and inflation fears mounted.^{1/} Based upon the public's interest in speculation and in precious metals a novel marketing device, styled the "margin account contract" was developed.^{2/}

Features of the Margin Account Contract^{3/}

5.02 The coin dealers or "exchanges" as they style themselves offer the investor the apparent opportunity to leverage his money by entering an agreement with the dealer under which the investor can purchase specific quantities of precious metal or currency, usually bags of pre-

1. See "Who's Holding The Bag?" Forbes, September 1, 1974, p. 32.

2. The Ontario Securities Commission reviewed the origin and development of the margin account contract in Re Pacific Coast Coin Exchange of Canada Limited and Monex International, Ltd. c/o/b Pacific Coast Coin Exchange (November, 1974 Ontario Securities Commission Bulletin 209). Monex, first a modest coin dealer, so successfully marketed the margin account concept that its gross business rose from \$10,000,000 in 1970, successively to \$30,000,000 in 1971, \$70,000,000 in 1972 and \$273,000,000 in 1973 with an appropriate pyramid in the first six months of 1974. More recently, Monex was enjoined in the United States through S.E.C. action: S.E.C. v. Monex International, Ltd. d/b/a Pacific Coast Coin Exchange Civ. A. No. 74-3634 (C.D. Cal., December 12, 1974).

3. See also In Re American Coin Exchange, Continental Coin Exchange, Pacific Coast Coin Exchange and Secure Monetary Systems, Inc., Determination by the Deputy Commissioner of Securities, State of Wisconsin, May 17, 1974.

1965 coins having a specific face value, e.g. \$1,000. The dealer fixes the price, known as the "base price", at which it is prepared to enter an agreement to sell the specific commodity, e.g. the bag of coins.^{4/} The purchaser has the option of purchasing the bag of coins outright or making payments in accordance with an over-riding agreement called a commodity account agreement.

5.03 The purchaser signs the agreement. Under it, if he does not wish to make a cash purchase, he is required to pay between 22% and 50% of the base price for each bag depending on the contract. In addition, he must pay a commission amounting in many cases to 2% of the base price at the time of the purchase and a selling commission of 2% of the then base or selling price at the time of a sale back to the dealer. The dealer has an obligation to deliver the coins only when the purchaser pays the unpaid portion of the original base price plus all commissions, interest, finance, maintenance and storage charges called for under the contract. Alternatively, the dealer holds out that it is willing (but not obliged) to repurchase at its current base price. So long as the bid is maintained the contract may be closed out without requiring delivery. The profit or loss on the contract is established by deducting from the then base or selling price the balance owing on the original base price less all outstanding interest, finance, maintenance and storage charges and of course the "sales" commission of 2%. These commission charges are added notwithstanding the fact the dealer acts as principal.

5.04 The contract gives the purchaser no more protection than a naked option. The dealer is under no obligation to hold or maintain physical commodities or futures contracts to meet the obligations under-

4. The base price is said to be fixed by the dealer by the subtraction of an equivalent to a carrying charge element from the publicly quoted price for the nearest futures month for that commodity and the evaluation of other elements such as the number and balance of the buy and sell orders received, the general economic conditions, etc.

taken through the margin account contract purchases.^{5/} The additional charges to the purchaser are of some interest. We have already noted that a sales commission is charged both ways notwithstanding the fact the dealer sells and purchases as principal. "Interest" is charged on an amount equal to the unpaid balance of the contract, variously styled interest, finance or maintenance charges based on an interest rate somewhat above the bank prime lending rate. "Storage" or some equivalent term is used to extract a further per bag fee each year. In the case of Monex the charge was \$10 per each \$1,000 face value bag contract. The margin contract used by Monex also provided for additional deposits resembling maintenance margin calls.

5.05 While the sales literature points up the possibility of taking delivery the investor is directed to the advantages of "leverage". Monex's experience was that over 85% of those entering contracts liquidated or closed then out without demanding delivery.

5.06 In its Monex reasons the O.S.C. did not dwell on the merits of the investment, but rather the need of the investor for information such as that found in a prospectus. The kind of disclosure made by Barrons in its June 3rd, 1974, article on margin account contracts commends itself. The article states, at page 37:

" For comparison, we chose a silver coin contract traded on the New York Mercantile Exchange covering 10 bags of silver, last week worth about \$3,600 apiece, or \$36,000 a contract. For a speculator [through a commodity futures contract] to buy that, he would have to put up slightly less than 10%, or around \$3,000 as margin, and his roundtrip commission [purchase and sale] is \$50.

However, if the same speculator went to one of the above-named shops, [coin exchanges], he would

5. California under its Commodity Law, a Division of the California Corporations Code, which extends to coin dealers' marketing margin account contracts does require that obligations to customers be covered or hedged in the cash or commodity markets to the extent of 95% to 105%: Section 350.537.6, Subchapter 2.9, Title 10, California Administrative Code, being Rules made under the California Commodity Law.

have to put up between 22% and 50% of the value of his investment as margin. If he wanted to buy 10 bags of coins, he might typically have to tie up 30% of his money - or \$10,800. He must pay 2% of the total value as his entry fee - that would be \$720 - and another 2%, or \$720, when he opts to get out. In addition, he is asked to pay an interest charge on the remaining part of his investment which, at 1% a month, would work out to \$3,024 for a year. Then there's a storage fee of \$10 per bag a year, or another \$100 a year.

All told, then, besides forking over three times as much margin, the typical coin investor is paying over \$4,000 in a year's time to maintain his position in 10 bags of silver. This sum compares with \$50 through a brokerage house on a recognized exchange (the Chicago Mercantile Exchange also has a contract in silver coins)."

6/

Regulatory Response

5.07 The mushrooming growth of these schemes, the vigorous and clever merchandising, the relatively unsophisticated persons to whom they appealed, coupled with a lack of specific regulatory machinery led to a checker board of responses. All securities administrators are concerned since, clearly, the Goldstein, Samuelson circumstances potentially exist.

5.08 First to act was California. The avenue by which it chose to regulate the coin dealers' margin account contract operations was under its Commodity Law, a Division of the California Corporations Code, signed into effect as emergency legislation September 25, 1973.

7/

5.09 The Congress of the United States, too, has determined to place these schemes under its extensively amended commodity legislation.

8/

Section 217 of the Commodity Futures Trading Commission Act of 1974 requires the newly created Commodity Futures Trading Commission (C.F.T.C.) to regulate transactions for the delivery of silver bullion, gold bullion,

6. See also "Who's Holding The Bag?" Forbes, September 1, 1974, p. 32.

7. See Chapter VI, para. 6.47 et seq.

8. Ibid. para. 6.01 et seq.

or bulk silver and gold coins pursuant to standardized contracts known as margin accounts, margin contracts, leverage accounts, or leverage contracts. All persons would be forbidden to enter into or confirm the execution of any such transaction contrary to any regulation of the C.F.T.C., brought down after public hearings, designed to ensure the financial solvency of such transactions and prevent manipulation of fraud. If the C.F.T.C. should determine that such transactions are contracts for future delivery within the meaning of the Commodity Exchange Act then they will be regulated in the same manner as are all commodity futures contracts under that Statute.

5.10 At the same time the U.S. federal Securities and Exchange Commission has been and is investigating trading in margin accounts on the premise they are securities by reason of being investment contracts. March 18, 1974 the Commission laid a complaint for violation of the U.S. federal securities laws against a company selling silver medallions and bullion by means of margin accounts^{9/} and, more recently, against Monex International, Ltd. which does business as Pacific Coast Coin Exchange.^{10/}

5.11 Other state jurisdictions in the United States have moved to establish that coin dealers' margin account contracts are securities

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9. S.E.C. v. Continental Silver Corporation of Nevada et al. Civ. A. No. 74-364 (D. Colo., March 18, 1974).
10. S.E.C. v. Monex International, Ltd. d/b/a Pacific Coast Coin Exchange, Civ. A. No. 74-3634 (C.D. Cal., December 12, 1974).

under their securities laws also on the premise they are investment contracts. 11/

5.12 In Re Pacific Coast Coin Exchange of Canada Limited and Monex International, Ltd. c/o/b Pacific Coast Coin Exchange ^{12/} the Ontario Securities Commission found the margin account contracts offered to be securities and made permanent its Order of October 11, 1974 that all such trading cease until a prospectus is submitted and accepted by the Commission in accordance with The Securities Act.

11. Coin dealers' margin contracts were found to be securities in State of Texas v. Secure Monetary Systems of Texas, Inc. N. 74-3028-H District Court of Dallas County, 160th Judicial District April 16, 1974 and State of Texas v. Joseph W. Pao and Jess M. McDonnell, d/b/a South West Coin Exchange No. 74-4117 E/D in the District Court of Dallas County, 95th Judicial District, May 15, 1974. However, in the State of Texas v. Monex International, Ltd. d/b/a Pacific Coast Coin Exchange No. 74-3243-A District Court of Dallas County 14th Judicial District, July 10, 1974 the State's case was dismissed.

July 26, 1974 in the People of New York v. Monex International, Ltd. d/b/a Pacific Coast Coin Exchange, Inc. (Supreme Court of the State of the State of New York, County of New York) plaintiff's motion for a preliminary injunction enjoining the defendants from engaging in margin contract transactions was granted in an interlocutory proceeding prior to trial of the issue. The Court found a prima facie case had been made out that the margin contracts were securities.

The Deputy Commissioner of Securities for the State of Wisconsin In Re American Coin Exchange, Continental Coin Exchange, Pacific Coast Coin Exchange and Security Monetary Systems Inc. Determination, May 17, 1974 found the manner or plan of business whereby the named companies offer and sell coins, bullion and foreign currencies on margin contracts to be an investment contract under that State's Blue Sky Law.

The Commission of Corporations, State of Oregon, also considers such margin account dealings to be securities: Letter of Commissioner of Corporations, State of Oregon, dated May 20, 1974 to Howard T. Rice, Messrs. Hyman and Rice concerning International Precious Metals Corporation.

12. November, 1974 Ontario Securities Commission Bulletin 209.

5.13 Subsequently, in a judgment handed down January 16, 1974^{13/}
the Divisional Court of the Supreme Court of Ontario confirmed the Commission's finding that the margin account contract was a form of investment contract and dismissed an appeal from that Order.^{14/}

13. Ontario Securities Commission and Pacific Coast Coin Exchange of Canada Limited and Monex International, Ltd. [1975] O.R. (2d) _____. At the date of writing leave to appeal from this judgment to the Court of Appeal for Ontario had been granted to Pacific Coast Coin Exchange of Canada Limited.

14. The law pertaining to the concept of investment contracts, while interesting, is complex and its elaboration here would not further this report. We direct those who wish to pursue the area to the cases to which we have referred and, in particular, to the decision of the Divisional Court of the Supreme Court of Ontario in the Pacific Coast Coin Exchange of Canada Limited appeal and the facts filed therein.

CHAPTER VI

REGULATION IN THE UNITED STATES: THE U.S. COMMODITY EXCHANGE ACT: THE CALIFORNIA COMMODITY LAW

A. FEDERAL REGULATION IN THE UNITED STATES - THE COMMODITY EXCHANGE ACT

Background

6.01 The American Congress after extensive hearings has now established, through major amendments to the federal Commodity Exchange Act, a comprehensive regulatory scheme for commodity trading in the United States.^{1/}

- I. The antecedents of the U.S. federal statute governing commodity futures trading, the Commodity Exchange Act, were the Futures Trading Act of 1921 and the Grain Futures Act of 1922. The former was a response to the demand for regulation growing out of the boom and bust of agricultural prices during and following the First World War and the latter was essentially the same legislation passed under the guise of a criminal statute purporting to prevent interference with interstate commerce when, within the year, the Futures Trading Act of 1921 was declared unconstitutional as an improper exercise of the taxing power. The Commodity Exchange Act of 1936 amended and enlarged the Grain Futures Act. The recent overhaul of the Commodity Exchange Act was affected by an amending statute, the Commodity Futures Trading Commission Act of 1974, U.S. Public Law 93-463, 93D Congress, H.R. 13113, October 23, 1974. For a background to these amendments see:

U.S. House of Representatives, Permanent Select Committee on Small Business, Hearings on Small Business Problems Involved in the Marketing of Grain and Other Commodities, 93D Congress 1st Session.

U.S. House of Representatives, Permanent Select Committee on Small Business, Report on Small Business Problems Involved in the Marketing of Grain and Other Commodities, 93D Congress 2d Session.

U.S. House of Representatives, Committee on Agriculture, Hearings on the Review of Commodity Exchange Act and Discussion of Possible Changes, 93D Congress 1st Session.

U.S. House of Representatives, Congressional Record, April 11, 1974.

U.S. House of Representatives, Committee on Agriculture, Hearings on the Commodity Futures Trading Commission Act of 1974, 93D Congress 2d Session.

U.S. House of Representatives, Report on Commodity Futures Trading Commission Act of 1974, 93D Congress 2d Session.

The experience of California, which regulates this area under its Commodity Law, a Division of the California Corporations Code, administered by the Commissioner of Corporations was felt helpful in reaching conclusions notwithstanding the fact that its operation has largely been circumscribed by the new federal legislation.^{2/}

6.02 Apart from California, other states in the United States have dealt with particular problems arising from trading in commodity futures contracts, commodity futures options and margin account contracts as securities matters, requiring the dealers to be licensed and commodity futures options and margin account contracts to be the subject of prospectus or registration requirements.

6.03 By the early 1970's the volume of commodity futures trading had increased enormously. In 1972-1973 it had reached a figure of four hundred billion dollars far exceeding the total value of securities transactions.^{3/} Much of the dramatic growth occurred in the broad spectrum of "international" commodities left unregulated under the Commodity Exchange Act of 1936. In this field, too, the naked commodity futures option blossomed.^{4/}

6.04 There were wide spread concerns about the abilities of the

U.S. Senate, Committee on Agriculture and Forestry, Hearings on Commodity Futures Trading Commission Act, Parts 1, 2 and 3, 93D Congress 2d Session.

U.S. Senate, Report on Commodity Futures Trading Commission Act of 1974, 93D Congress 2d Session.

2. The Canadian Grain Futures Act of 1939, R.S.C. 1970, c. G-17, which provides for federal regulation of futures trading on the Winnipeg Commodity Exchange, formerly the Winnipeg Grain Exchange, though proclaimed in force has never been implemented. It is considered in Chapter VII.

The United Kingdom, Australia and New Zealand have no formal government regulation touching specifically on commodity futures trading.

3. "New investments in commodity futures are coming from the securities markets, attracted by price leverage, low margin requirements, volatile price action": U.S. House of Representatives, Report on Commodity Futures Trading Commission Act of 1974, 93D Congress 2d Session, p. 39.
4. See Chapter IV, para. 4.12 et seq.

commodity exchanges to regulate themselves to the degree that had been contemplated and countenanced by The Commodity Exchange Act. The hedgers complained that the traditional relationship between cash and futures prices was distorted. Hedging, which depended in part on borrowed money to meet margin requirements, was thus more costly. It was alleged that manipulative activities heightened price swings in times of commodity shortages.

6.05 As a result of these concerns, exhaustively dealt with in Congressional proceedings,^{5/} the United States Congress passed, and on October 23rd, 1974, the President signed, the Commodity Futures Trading Commission Act of 1974, a statute which substantially amends the Commodity Exchange Act. These amendments come into force in April, 1975.^{6/}

Scope of the New Legislation

6.06 The present Commodity Exchange Act applies only to the commodities specifically designated, largely domestic agricultural products.^{7/}

5. See supra. footnote 1.

6. Full implementation of the changes may take longer than has been planned: "New Panel to Oversee Futures Is Lagging in Starting Up: White House Gets Blame", The Wall Street Journal, December 30, 1974 p. 14.
7. Section 2(a) of the Commodity Exchange Act designates the following commodities:

Barley	Livestock
Butter	Livestock products
Corn	Mill feeds
Cotton	Oats
Cottonseed	Onions (but futures
Cottonseed meal	trading presently
Eggs	prohibited under U.S.
Fats and oils	P.L. 85-839
(including lard, tallow,	August 1952)
cottonseed oil, peanut	Peanuts
oil, soybean oil, coco-	Rice
nut oil and all other	Rye
fats and oils)	Soybeans
Flaxseed	Soybean meal
Frozen concentrated	Wheat
orange juice	Wool
Grain sorghums	Wool tops
Irish potatoes	

This list does not include a large number of important commodities on which futures contracts are traded on United States commodity exchanges.^{8/} The amendments will extend coverage to include all other goods and articles and all services, rights and interests in which contracts for future delivery are presently or in the future may be dealt with.^{9/}

6.07 The amendments recognize that a great deal of the trading in foreign currency is conducted through an informal network of banks. The regulation of trading in foreign currency will be left to the banking authorities and transactions in foreign currency exempted from the operation of the amendments. Again recognizing the role of other regulatory agencies and the financial institutions regulated by them, the amendments will exempt transactions in security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, mortgages and mortgages purchase commitments unless the contract is executed on a formally organized futures exchange.

6.08 The ban on trading in options on commodities specifically designated under the Act will continue.^{10/} Trading in options on commodities brought under the Act for the first time will be permitted if not contrary to regulations established by the newly established Commodity

8. Some major commodities traded on commodity exchanges and not regulated under the present Commodity Exchange Act:

Aluminum	Iced broilers	Plywood
Apples	Lead	Propane gas
Cocoa	Lumber	Silver
Coffee	Mercury	Sugar
Copper	Nickel	Silver coins
Fishmeal	Palladium	Tin
Foreign currency	Platinum	Tomato paste

9. Section 201, Commodity Futures Trading Commission Act of 1974, hereinafter cited as '74 Amendments. References to the '74 Amendments will be followed by references to the sections of the Commodity Exchange Act amended or introduced thereby, in this case Section 2(a).

10. Section 402, '74 Amendments; Section 4c(a), Act.

Futures Trading Commission. ^{11/}

6.09 Transactions involving the delivery of silver bullion, gold bullion, or bulk silver or gold coins pursuant to standardized contracts known as margin accounts, margin contracts, leverage accounts or leverage contracts are to be regulated. ^{12/} The amendments contemplate public hearings to develop regulations ensuring the financial abilities of those writing such agreements and preventing manipulation or fraud. If the Commodity Futures Trading Commission determines that such transactions are contracts for future delivery within the meaning of the Commodity Exchange Act they will be regulated in the same manner as are all commodity futures contracts under that Act.

The Commodity Futures Trading Commission (C.F.T.C.)

6.10 Recognizing the scope of necessary regulation went far beyond the bounds of agricultural products, the amendments have created a fully independent five-man regulatory commission, the Commodity Futures Trading Commission (C.F.T.C.). The authority presently charged with operating responsibility for the Act's administration, the Commodity Exchange Authority, is a bureau within the Department of Agriculture and under the supervision of the Secretary of Agriculture. ^{13/} As a gesture to the traditional relationship specific provision is made for the new Commission to maintain liaison with the Department of Agriculture. ^{14/}

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11. Section 402, '74 Amendments; Section 4c(b), Act. These regulations are to be promulgated within one year of the effective date of the amendments, and shall describe terms and conditions of trading which may vary from market to market.
12. Section 217, '74 Amendments. See supra. Chapter V.
13. Formal responsibility for the administration of the Commodity Exchange Act until the recent amendments has resided in the Commodity Exchange Commission composed of the Secretary of Agriculture, the Secretary of Commerce and the Attorney General, and in the Secretary of Agriculture in his own right. In reality, the Commodity Exchange Commission was an inactive body.
14. Section 101(a)(3), '74 Amendments; Section 2(a)(8), Act.

Self-Regulation

6.11 ^{15/} The principle of self-regulation is encouraged in the legislation. ^{16/} Persons in the commodity trading business registered under the Act, subject to the approval of the Commission, may establish an association which will have authority to regulate the practices of its members and provide procedures for the settlement of complaints and claims similar to those existing for commodity exchanges.

Commodity Exchanges

6.12 Futures trading in any specific commodity must be conducted only on commodity exchanges designated as a "contract market" for that particular commodity. ^{17/} A commodity exchange will be designated as a contract market if certain specified conditions exist. ^{18/} For instance, the exchange should be located where the commodity exists in sufficient quantities to reflect value and grade differences and there are approved quality inspection services, or, if it is not so located it provides for delivery of commodities on its contracts at points and upon terms approved by the C.F.T.C. The governing board of the exchange must require the filing of prescribed reports. Steps must be taken to prevent the dissemination of false market information, to prevent the manipulation of prices, the cornering of any commodity, and to enforce the C.F.T.C.'s orders denying trading privileges. The exchange will now have to demonstrate that futures trading in the commodity for which designation as a contract market is sought will not be "contrary to the public interest" ^{19/}

15. Section 301, '74 Amendments; Section 17, Act.

16. Infra. para. 6.17.

17. Section 4, Act.

18. Section 5, Act.

19. Section 207, '74 Amendments; Section 5(g), Act.

6.13 Each contract market must furnish the C.F.T.C. with copies of all by-laws, rules, regulations and resolutions and any amendments. Its records are to be open for inspection and the operators of warehouses out of which commodities are deliverable on futures contracts must make and keep such records and permit such inspection as may be prescribed. To prevent "squeezes" and market congestion the contract market must, if directed, provide for a period after trading in futures contracts in a delivery month has ceased during which the futures contracts may be satisfied by the delivery of the actual cash commodity.^{20/}

6.14 Contract markets must require the party making delivery of the cash commodity under the futures contract to furnish the party obligated to accept delivery written notice at least one business day prior to delivery, or such longer period as is prescribed. The commodities must be of grades conforming to promulgated United States Standards. Receipts issued under the U.S. Warehouse Act must be accepted in satisfaction of the futures contract provided the warehouse meets reasonable requirements as to location, accessibility and suitability for warehousing and delivery purposes.^{21/}

6.15 Contract markets must enforce their by-laws, rules, regulations and resolutions which have not been disapproved by the C.F.T.C. They must revoke those that have been disapproved. They must establish and enforce their financial standards and related reporting requirements.^{22/}

6.16 The amendments require that the contract markets permit delivery at such points and at such quality and locational price differentials as will prevent or diminish price manipulation, market congestion or the abnormal movement of the commodity in interstate commerce. The C.F.T.C.

20. Section 5a, Act.

21. Ibid.

22. Ibid.

can designate additional delivery points after the contract market has an opportunity to be heard if these objectives are not met.^{23/}

6.17 The contract markets must establish a customer claims settlement procedure for the handling of customer complaints which involve claims of up to \$15,000 and which result in a voluntary informal settlement between the parties.^{24/}

6.18 The contract market must submit to the C.F.T.C. for approval all by-laws, regulations and resolutions which relate to the terms and condition of futures contracts except those relating to the setting of margin levels.^{25/} The C.F.T.C. can, after notice and hearing, require the contract market to effect changes in its rules and practices which the C.F.T.C. determines to be necessary or appropriate for the public interest^{26/} dealing with such matters as:

- (a) terms or conditions in contracts of sale to be executed on or subject to the rules of such contract market;
- (b) the form or manner of execution of purchases and sales for future delivery;
- (c) other trading requirements, excepting the setting of levels of margins;
- (d) safeguards with respect to the financial responsibility of members;
- (e) the manner, method and place of soliciting business, including the content of such solicitations; and
- (f) the form and manner of handling, recording and accounting for customers' orders, transactions and accounts.

23. Section 208(d), '74 Amendments; Section 5(a)10, Act. See also the comments of the U.S. Assistant Secretary of Agriculture on the need for this provision at p. 77 of U.S. House of Representatives, Report on Commodity Futures Trading Commission Act of 1974, 93D Congress 2d Session.

24. Section 209, '74 Amendments; Section 5a(11), Act.

25. Section 210, '74 Amendments; Section 5a(12), Act.

26. Section 213, '74 Amendments; Section 8a(7), Act.

6.19 In an "emergency" the C.F.T.C. may direct a contract market to take such action as is necessary to maintain or restore orderly trading in, or the liquidation of any futures contract.^{27/} "Emergency" is defined to include:

"...in addition to threatened or actual market manipulations and corners - any act of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand..."

Discipline - Exchange Members

6.20 The C.F.T.C. has the power to discipline exchange members if the exchange fails to act and has the power to review any exchange disciplinary action.^{28/} It may suspend for a period of up to six months or may revoke the designation of an exchange as a contract market if the exchange fails or refuses to comply with any of the provisions of the Act, rules or regulations.^{29/} In lieu of a suspension or revocation order the C.F.T.C. may issue a cease and desist order if any exchange or any director, officer, agent or employee of the exchange violates any provisions of the Act or the regulations.^{30/}

Trading Records - Published Reports

6.21 Clearing houses are required to maintain daily trading records the content of which is left to the C.F.T.C. to prescribe.^{31/} The C.F.T.C. may require reports made from such records at such times and in such form

27. Section 215, '74 Amendments; Section 8a(9), Act.

28. Section 216, '74 Amendments; Sections 8c(2) and (3), Act.

29. Section 5b, Act.

30. Section 6b, Act.

31. Section 415, '74 Amendments; Section 4g(2), Act.

as it may determine.^{32/} Exchanges are required to make public before the beginning of trading each day the volume of trading on each type of contract for the previous day.^{33/}

Futures Commission Merchants and Floor Brokers -
Salesmen - Conditions of Registration

6.22 A "futures commission merchant" is defined as:^{34/}

"individuals, associations, partnerships, corporations and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities or property (or extends credit in lieu thereof) to margin, guarantee or secure any trades or contract that result or may result therefrom."

6.23 A "floor broker" is defined as:^{35/}

"any person who, in or surrounding any 'pit', 'ring', 'post', or other place provided by a contract market for the meeting of persons similarly engaged, shall purchase or sell for any other person any commodity for future delivery on or subject to the rules of the contract market."

6.24 All futures commission merchants and floor brokers must register with the C.F.T.C. annually.^{36/} The legislation now extends to require the registration of salesmen employed by futures commission merchants. New fitness requirements will be provided to be applied to all individuals employed by futures commission merchants and involved in the solicitation or acceptance of customers' orders, other than in a clerical capacity, or those supervising such persons.^{37/}

32. Section 415, '74 Amendments; Section 4g(4), Act.

33. Section 415, '74 Amendments; Section 4g(5), Act.

34. Section 2(a)1, Act. See supra. Chapter III, para. 3.25.

35. Ibid. See supra. Chapter III, para. 3.26.

36. Sections 4d, 4e, Act.

37. Sections 204a and 206, '74 Amendments; Sections 4k(1) and 4p, Act.

6.25 The C.F.T.C. is to establish appropriate standards with respect to trading and experience in order to assure the qualifications of futures commission merchants, floor brokers and those persons associated with them. It may prescribe a written examination^{38/} or may accept written proficiency examinations established by contract markets or futures associations registered under the new Act. The C.F.T.C. may specify the terms and conditions under which an individual is exempted from any written examination because he has demonstrated through training and experience that he has the necessary degree of skill and proficiency.

6.26 Minimum financial requirements for futures commission merchants will be established by the C.F.T.C. and registration will be conditioned on compliance. Alternatively, they may comply if they are a member of a contract market and conform with the financial standards and reporting requirements of that exchange, as approved by the C.F.T.C.^{39/} Registration as a floor broker is not conditioned upon any prescribed minimum capital requirements.

6.27 Each futures commission merchant and floor broker must make the required reports, maintain and make available books and records with respect to their own and customers' transactions and positions.^{40/} Futures commission merchants must segregate and separately account for money,^{41/} securities and other property received from or accruing to customers.

Discipline - Futures Commission Merchants - Floor Trading

6.28 The C.F.T.C. may suspend for up to six months or revoke the registration of a futures commission merchant or floor broker if the regis-

38. Section 206, '74 Amendments; Sections 4k(1) and 4p, Act.

39. Section 4f(2), Act.

40. Section 4g, Act.

41. Section 4d(2), Act.

trant is found manipulating the price of either cash commodities or futures, to have made false or misleading statements, or willfully omitted material facts in any application or other report or is otherwise violating or has violated the Act, rules or regulations.^{42/}

Conflict of Interest - Self-Dealing

6.29 The legislation gives the responsibility to the C.F.T.C. to determine after hearings within six months of its effective date whether floor brokers and futures commission merchants should continue to be permitted to trade for their own account and at the same time for their customers. If the C.F.T.C. concludes that it will permit such trading then it will describe the circumstances under which it may be conducted. It shall make separate determinations for each contract market taking into account, at a minimum, the effect of their decision upon liquidity.^{43/}

Commodity Trading Advisors - Commodity Pool Operators

6.30 For the first time advisors are required to obtain registration.^{44/} A "commodity trading advisor" is defined as:

"any person who, for compensation or profit engages in the business of advising others either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who, for compensation or profit, and as a part of a regular business, issues or promulgates analyses or reports concerning commodities; but does not include, (i) any bank or trust company, (ii) any newspaper reporter, newspaper columnist, newspaper editor, lawyer, accountant, or teacher, (iii) any floor broker or futures commission merchant, (iv) the publisher of any bona

42. Section 6(b), Act. Manipulation or attempted manipulation of the cash or futures markets or other violations of the Act, rules or regulations are also subject to criminal sanction.

43. Section 203, '74 Amendments; Section 4j, Act.

44. Section 205, '74 Amendments; Section 4m, Act.

fide newspaper, news magazine or business or financial publication of general and regular circulation including their employees, (v) any contract market; and (vi) such other persons not within the intent of this definition as the Commission may specify by rule, regulation or order: provided that the furnishing of such services by the foregoing persons is solely incidental to the conduct of their business or professions." 45/

6.31 The new registrations requirements 46/ also provide for a similar category, the "commodity pool operator", whose activities are defined as follows:

"any person engaged in a business which is of the nature of an investment trust, syndicate or similar form of enterprise, and who, in connection therewith, solicits, accepts or receives from others funds, securities or property either directly or through capital contributions, the sale or stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, but does not include such persons not within the intent of this definition as the Commission may specify by rule or regulation or by order." 47/

6.32 These registrants must maintain satisfactory books and records and furnish reports as are required. Upon request of the C.F.T.C. they must furnish the name and address of each client, subscriber or participant and submit samples or copies of all literature or advice distributed to clients, subscribers or participants or prospective clients, subscribers or participants. They shall make full and complete disclosure to their subscribers, clients or participants of all futures market positions taken or held by the individual principals of their organizations. 48/

45. Section 202, '74 Amendments; Section 2(a)(1), Act.

46. Section 205, '74 Amendments; Section 4m, Act.

47. Section 202, '74 Amendments; Section 2(a)(1), Act. Commodity pools are seemingly mutual funds based upon commodity futures contracts. The commodity pool operator appears to be a combination of the fund itself and the mutual fund manager.

48. Section 205, '74 Amendments; Section 4n(4)(A)-(B), Act.

Discipline - Commodity Trading Advisors - Commodity Pool Operators

6.33 The C.F.T.C. may deny registration to any person as an advisor or operator if such person is subject to any outstanding order of the C.F.T.C. denying such person trading privileges in any contract market or suspending or revoking the registration of such person as a commodity trading advisor, commodity pool operator, futures commission merchant or floor broker or suspending or expelling such person from membership on any contract market. The C.F.T.C. may deny, revoke or suspend the registration of any advisor or operator if it finds that such person's operations disrupt orderly markets, cause unreasonable fluctuations or unwarranted changes in commodity prices, or such person, partner, officer, director or controlling person has been convicted within a ten year period of a commodity or securities related offence or is enjoined from engaging in the commodities or securities business or any partner, officer, director or controlling person is subject to an order denying trading privileges, suspending or revoking registration or expelling him from membership in a contract market.^{49/}

Control of Manipulation and Excessive Speculation

(1) Dissemination of Information

6.34 Full, true and plain disclosure of all material facts is one of the most effective means of frustrating manipulation. The C.F.T.C. has broad powers to make investigations and furnish reports to the public including information as to trading, marketing conditions, and supply, demand, prices and other conditions of commodities markets both in the United States and other countries.^{50/} The C.F.T.C. may publish the results

49. Section 205, '74 Amendments; Section 4n(6), Act; Section 205, '74 Amendments; Section 4n(7), Act.

50. Section 414, '74 Amendments; Section 16, Act.

of investigations into the operations of commodity exchanges and other persons subject to the Act, provided it does not disclose the transactions of any person, trade secrets or customers' names.^{51/}

(2) Surveillance - Reporting

6.35 Surveillance of large accounts assists in the detection of manipulation and serves to thwart it. The C.F.T.C. requires daily reports with respect to any commodity, whether in the cash or futures market, greater than an amount fixed by the C.F.T.C., from any person who in that day, directly or indirectly has or achieves a long or short position greater than the limit in the commodity. The requirement covers all accounts controlled directly or indirectly, and includes all deliveries made or received and all contracts open at the end of the day. Open contracts must be classified as speculative or hedging.^{52/}

(3) False Crop Information - Criminal Sanction

6.36 The Act^{53/} provides criminal sanctions for knowingly transmitting through the mails or in interstate commerce false, misleading or inaccurate reports concerning crop or market information or conditions that affect commodity prices.^{54/} The commodity exchanges are required to adopt rules to prevent the dissemination of such information.^{55/}

(4) Speculative Limits: Trading Limits - Position Limits

6.37 To prevent an individual or group from obtaining control of

51. Section 8, Act.

52. Section 4i, Act.

53. Section 9(b), Act.

54. Under Section 338 of the Criminal Code (Canada) anyone who by, "deceit, falsehood or other fraudulent means...with intent to defraud, affects the public market price of...anything that is offered for sale to the public, is guilty of an indictable offence..."

55. Section 5, Act.

the market in a commodity and to minimize the unsettling effect on prices caused by the liquidation of large positions, the C.F.T.C. may fix daily "trading limits", that is the maximum amounts which a speculator may trade in one day,^{56/} and "position limits", the maximum total open contracts which a person may hold or control at any time in a commodity.^{57/} Excepted from these limits will be "bona fide hedging transactions or other positions", a term which the new C.F.T.C. must redefine within 3 months of the effective date of the amendments.^{58/}

56. These daily "trading limits" are not to be confused with the maximum daily permissible price changes commodity exchanges set for each commodity i.e., certain amounts above or below the previous day's closing price beyond which limits no trades may be effected.

57. Section 4a, Act. Presently, federal speculative limits apply to some commodities, exchange speculative limits to others while some are not subject to limits at all.

58. Under the present definition in Section 4a(3), bona fide hedges include, generally:

(1) a sale of a futures contract (short position) that is offset by the ownership or purchase at a fixed price of the same cash commodity, or

(2) a purchase of a futures contract (long position) that is offset by sales of the same cash commodity at a fixed price, or

(3) a sale of a futures contract (short position) that is offset by the amount of a commodity a person is raising, or in good faith expects to raise, within the next twelve months, on land that person owns or leases, or

(4) a sale of a futures contract (short position) in a commodity that is a reasonable hedge against products or byproducts owned or purchased, or

(5) a purchase of a futures contract (long position) in a commodity that is a reasonable hedge against the sale of any product or byproduct, or

(6) a purchase of a futures contract (long position) to fill the anticipated requirements of a processor or manufacturer for a specified period of not more than one year.

See U.S. Department of Agriculture, Commodity Exchange Authority, Federal Regulation of Trading in Commodity Futures Contracts, Washington, D.C., September 1973.

(5) Stabilization Immediately Prior to Contract Maturity

6.38 Most contracts are closed out by offset prior to the contract date. As the contract maturity date draws closer those obliged to take delivery under the contract may rush out in an attempt to close out their positions thus affording those who sold short an opportunity of offsetting their contracts at sharply deflated prices. Indeed, the shorts may encourage them to do so by delaying closing out their short positions. The C.F.T.C. has the power to intervene to alleviate in two respects. Firstly, it can compel contract markets to require the shorts to furnish the longs with written notice up to 10 days ahead of intended delivery.^{59/} On the other hand, the supply of a commodity can be increased, relieving the pressure on the shorts, through the C.F.T.C. directing the contract markets to provide for a period after trading in futures contracts in a delivery month has ceased during which futures contracts may be satisfied by delivery of the cash commodity.^{60/} The requirement in the Act that contract markets

Dissatisfaction arose over this "mechanical test" of hedging because it permits "double hedging" i.e., a situation where a firm with an inventory of a particular commodity and also fixed price sales can hedge the two sides independently, going short in futures on the inventory and long on the fixed price sales, rather than netting the two positions out and hedging net. At the least, double hedging contributes to the possibility of market congestion. More ominously, there have been allegations that the double hedge deliberately has been used as a device to reap speculative profits. As some firms initially holding a large double hedge lift their short position by offset, this action, if representing significant volume, may bid up the price of contracts thereby benefitting their remaining open long position. It is to correct this and other perceived shortcomings that Congress directed the term "bona fide hedging transactions" be redefined. See U.S. House of Representatives, Committee on Agriculture, Hearings on the Review of Commodity Exchange Act and Discussion of Possible Changes, 93D Congress 1st Session, pp. 31-32; U.S. House of Representatives, Committee on Agriculture, Hearings on the Commodity Futures Trading Commission Act of 1974, 93D Congress 2d Session, pp. 59-60; U.S. House of Representatives, Report on Commodity Futures Trading Commission Act of 1974, 93D Congress 2d Session, p. 32; U.S. Senate Committee on Agriculture and Forestry, Hearings on Commodity Futures Trading Commission Act of 1974, 93D Congress 2d Session, p. 26

59. Section 5a(5), Act.

60. Section 5a(4), Act.

must accept warehouse receipts issued under the United States Warehouse Act^{61/} and the C.F.T.C.'s power to designate additional delivery points^{62/} also, in effect, increase the supply of the commodity and are, therefore, further stabilizing aids.

(6) Prohibition of Bucketing and Cross Trades

6.39 "Bucketing" and "cross-trading" are prohibited^{63/} because the trades are not arrived at through open and competitive auction or because the prices at which they occur are not reported. Bucketing is described as "directly or indirectly taking the opposite side of a customer's order into the handling broker's own account or into an account in which he has an interest without bona fide execution in accordance with the rules of a contract market."^{64/} "Cross-Trading" is described as, "indirectly bucketing a customer's order or indirectly offsetting the buying order of one customer against the selling order of another customer, or wash trading by means of transactions with another floor broker who is engaged in a similar type of trading."^{65/}

6.40 Transactions employed to cause any price to be reported, registered or recorded which is not a true price are prohibited not only because they do not represent the true auction market but in addition give a fic-

61. Section 5a(7), Act.

62. Section 208(d), '74 Amendments; Section 5a(10), Act.

63. Sections 4(b)1 and 4(c) (A), Act.

64. Commodity Exchange Authority, Memorandum on Certain Trade Practices Prohibited by the Commodity Exchange Act, May 25, 1966.

Gaming in the rise or fall in the price of "goods, wares or merchandise" is prohibited by Section 341 of the Criminal Code (Canada).

65. Ibid.

titious or are non-arms length entered into for the purpose of creating the fictitious appearance. This includes "accommodation trades"^{66/} that is, trades entered into by one broker to assist another broker to make cross trades or wash trades thus creating the false appearance of market activity where no real contracts actually result from the apparent trades or "wash trades",^{67/} that is, trades entered into or purported to be entered into for the purpose of creating the appearance of actual purchases and sales but without any real change in position.^{68/}

6.41 In a Canadian context to provide further criminal sanctions would require amendments to The Criminal Code. Manipulation of the cash or futures price of a commodity or cornering any commodity is a crime under the U.S. Act.^{69/}

(7) Administrative Sanctions

6.42 We have previously noted that the C.F.T.C. can suspend the trading privileges of any person found to be manipulating or attempting to manipulate the market price of regulated cash commodities or futures.^{70/} This type of conduct provides grounds for suspending or cancelling the registration of a future commission merchant, floor broker or any other registrant. While it is a condition of designation as a contract market that the exchange prevent manipulation and cornering, if the exchange is unable to discharge this obligation the C.F.T.C. may suspend the exchange's designation as a contract market.^{71/}

66. Section 4(c) (A), Act.

67. Ibid.

68. In the absence of specific provision in the Criminal Code (Canada) reliance would be placed on Section 338(2) - fraudulent affecting the public market price of stocks, shares, merchandise or anything that is offered for sale to the public.

69. Section 9(b), Act.

70. Section 6(b), Act.

71. Sections 5 and 5b, Act.

Protection of Customers

6.43 The Act, in broad terms, makes it unlawful to cheat the customer.^{72/} However, a provision which would have required the futures commission merchant or advisor to obtain a statement from every new customer that he understands the speculative nature of futures contract trading and the high probability of loss of investment in futures contracts which was introduced in the Senate version of the amendments did not find its way into the Commodity Futures Trading Commission Act of 1974 as enacted.

6.44 We earlier considered the conditions of registration for futures commission merchants and commodity trading advisors designed to protect the customer and to provide him with information. This included, in the case of the futures commission merchants, the segregation and separate accounting for customers' margin funds and moneys accruing to customers.^{73/} Failure to do so is a criminal offence under the Act.^{74/}

6.45 Section 106 of the amendments^{75/} introduces a customers' reparation procedure which enables the customer, within a three year period, to lodge a complaint before the C.F.T.C. as to his dealings with a futures commission merchant. A non-resident of the United States must furnish a bond in double the amount of the claim before formal action will be taken on the complaint. The C.F.T.C.'s decision is subject to judicial review.^{76/}

6.46 The amendments require the C.F.T.C. to report to Congress by the summer of 1976 on the desirability of legislation insuring individual customers' accounts against loss through the failure of a futures commission

72. Section 4b, Act.

73. Section 4d(2), Act.

74. Section 9(a), Act. In the Canadian context see Sections 290 to 292 of the Criminal Code (Canada).

75. Section 14(a), Act.

76. As opposed to the practice in the United States, it is not the policy in Ontario to have governmental agencies intervene in disputes between private parties. Resolution of such matters is left to the courts.

merchant.^{77/}

B. THE CALIFORNIA COMMODITY LAW

Background

6.47 On September 25th, 1973, exercising the emergency authority vested in him, the Governor of the State of California signed into law comprehensive commodities legislation, styled the California Commodity Law, enacted as a Division of the California Corporations Code and administered by the Commissioner of Corporations.^{78/} As we noted previously^{79/} California was particularly concerned about naked commodity futures options, and the problems which flowed from them. Indeed, they had successfully proceeded against naked options firms as dealing in securities without registration under the California Corporate Securities Law. However, it was deemed appropriate to have specific law governing trading in options and that in margin account contracts by the self-styled coin exchanges.^{80/}

Summary of Provisions

6.48 The Law requires a commodity exchange to obtain a license unless it is designated as a "contract market" under the federal Commodity Exchange Act or is otherwise exempted. "Commodity solicitors" (futures commission merchants) and floor brokers must obtain certification from the Commissioner of Corporations or be registered with a licensed exchange

77. Section 417, '74 Amendments.

78. California Assembly Bill 799, 1973. The administration of the new Division is in addition to the other responsibilities of the Commissioner of Corporations which include administration of the Corporate Securities Law and the Franchise Investment Law.

79. Supra. Chapter IV, para. 4.12 et seq.

80. See Chapter V.

unless registered under the federal Commodity Exchange Act or otherwise exempted. Salesmen employed by commodity solicitors and floor brokers must also be licensed by the Commissioner or registered with a licensed exchange unless their employers are registered under the federal Commodity Exchange Act or otherwise exempted. Commodity advisers must be licensed. A class of registrant was established called "commodity option issuers", defined as, "any person who engages in the business of issuing options to acquire or to sell a commodity futures contract". Both they and their salesmen must be licensed. All commodity option issuers must secure a prescribed permit authorizing the offer and sale of commodity option contracts and the giving of any guarantee in connection with them. All licensees or registrants must meet standards of financial responsibility and experience and must conform with additional investor protection measures set out in the Law.

6.49 Exemptions in the California Commodity Law will operate to remove from that State's licensing requirements commodity exchanges, futures commission merchants, floor brokers, and their salesmen as they become registered under the amended federal Commodity Exchange Act. It is probable that California will extend a similar exemption to commodity advisers, a classification which did not exist in the federal Act when California drafted its Commodity Law. With respect to trading in options, and the coin dealers' margin or leverage accounts, it remains to be seen whether the regulations to be promulgated by the newly established federal Commodity Futures Trading Commission will be such as to encourage California to relinquish all regulatory responsibility in this area in favour of the federal authority.

CHAPTER VII

PROPOSED FEDERAL REGULATION OF COMMODITY FUTURES TRADING IN CANADA: THE GRAIN FUTURES ACT OF 1939

The Federal Royal Commission Reports of 1925, 1931 and 1938

7.01 The response to the dissatisfaction of Western grain farmers with the functioning of futures markets in Canada was the appointment of three Royal Commissions.^{1/} Each Commission's report favoured the open market as a preferred method for marketing Western grains and futures trading as an adjunct to that system. However, both the 1931 and 1938 reports advocated Government regulation over the Winnipeg Grain Exchange, now the Winnipeg Commodity Exchange, because of the general suspicion held by producers of its members' motives and activities. In commenting upon this the 1931 report noted, at page 60, that the Exchange was the judge in its own cause although through its by-laws and regulations it was alive to the desirability of checking and abolishing every kind of undesirable practice. The report continues:

"We are given to understand that it does, in effect, without parade or publicity, uphold the standard of business conduct and correct any undesirable practices amongst its members. But apparently, all this, happening behind closed doors has not availed to improve public psychology or sentiment."

7.02 It might be noted here that in the early 1970's the Board of Governors of the Winnipeg Commodity Exchange instituted a program to explain the Exchange's function and its workings to Western producers and

1. Report of the Royal Grain Inquiry Commission (1925), King's Printer, Ottawa, Report of the Commission to Enquire Into Trading in Grain Futures (1931), King's Printer, Ottawa, Report of the Royal Grain Inquiry Commission (1938), King's Printer, Ottawa.

consumers. The outcome of the rapeseed plebiscite of 1973^{2/} may be some indication of the success of these efforts.

The Grain Futures Act, 1939

7.03 The result of the 1938 Commission was the passage of the federal Grain Futures Act in 1939.^{3/} Although this Act was proclaimed in force August 1st, 1939, because of the outbreak of World War II and events following, it has never been implemented.

7.04 The Act was designed to provide regulation for futures trading in only six crops - wheat, oats, barley, rye, flaxseed and corn^{4/} - on the Winnipeg Grain Exchange, now the Winnipeg Commodity Exchange.^{5/} Regulation was to be vested in the Board of Grain Commissioners (the "B.G.C."), now the Canadian Grain Commission. An officer of the B.G.C. was to be appointed by the Cabinet as Supervisor.^{6/} The Supervisor was to observe and report to the B.G.C. on trading and to immediately advise the B.G.C. of any indications of a condition prejudicial to the public interest.^{7/}

Regulation of the Winnipeg Commodity Exchange
and Winnipeg Commodity Clearing Limited 8/

7.05 Subject to federal Cabinet approval the B.G.C. may make regulations requiring the members of the predecessor Winnipeg Grain Exchange

2. Infra. para. 7.15.

3. S.C. 1939, c. 31, now R.S.C. 1970, c. G-17.

4. The term "grain" as used in the Act is defined by Section 2(1) as meaning these six crops.

5. As early as 1938 the Board of Governors of the Exchange welcomed the principle of federal government supervision and has consistently over the intervening years held to, and voiced, this attitude.

6. See Section 4.

7. Section 6.

8. Formerly the Winnipeg Grain Exchange and Winnipeg Grain and Produce Exchange Clearing Association Limited.

and Winnipeg Grain and Produce Exchange Clearing Association Limited to register with the B.G.C. The B.G.C. can make regulations respecting records, the furnishing of information concerning trading in grain futures, maintenance of trading records and can require the use of the Exchange's best efforts to obtain specific particulars of all transactions in grain futures from their members' agents and correspondents. The Supervisor has the power to inspect books and records maintained by the Exchange, the Clearing corporation and the members. The B.G.C. has the power to require or to publish information and statistics relating to the marketing of grain.^{9/}

Investigations

7.06 The B.G.C., either on its own motion or on the basis of complaints is empowered to make inquiries into transactions in grain futures on the Exchange.^{10/}

Market Stabilization

7.07 Where the B.G.C. is of the opinion that trading in grain futures is causing or threatening to cause sudden or undue fluctuations in the price of any grain it may fix minimum margins, establish daily "trading limits" (maximum amounts of any grain futures which a speculator may trade in any one day)^{11/} and "position limits" (maximum total open contracts which a person may hold at any one time in any grain). It would exempt from such limits bona fide hedging transactions, i.e.:

"...grain futures to the extent that such contracts are

9. Section 5(1) clauses (a) to (f).

10. Section 7.

11. These daily "trading limits" are not to be confused with the maximum daily permissible price changes commodity exchanges set for each commodity i.e., certain amounts above or below the previous day's closing price beyond which limits no trades may be effected.

offset in quantity by

- (a) the purchase or sale of cash grain;
- (b) the ownership of grain or of products or by-products thereof; or
- (c) the ownership of grain growing on land owned or leased by the owner of such grain" ^{12/}

Disciplinary Powers - Administrative Sanctions

7.08 The B.G.C. may suspend from trading privileges an Exchange member who, in the opinion of the B.G.C., has been guilty of a breach of the Act or of orders or regulations thereunder and require officials of the Exchange to enforce such suspension and forbid any other member to accept other than liquidating orders from the suspended member. ^{13/}

7.09 The B.G.C., where in its opinion, a by-law or rule of the Exchange has brought about or is threatening to bring about a condition prejudicial to the public interest, after hearing representations on behalf of the Exchange, by order may revoke or vary such by-law or rule. It is not, however, authorized to close the grain futures market or to impose any limitations other than those just described. ^{14/}

7.10 The B.G.C. may hear appeals from Exchange committee decisions with respect to disputes over alleged failures to deliver in accordance with contract terms and to make any determination that in its opinion ought to have been made by the Exchange committee. ^{15/}

7.11 By Section 11 each decision of the B.G.C. outlined above may be appealed by any aggrieved person to the Minister of Agriculture.

12. Section 8(2).

13. Section 8(1).

14. Section 8(3).

15. Section 10.

Sanctions

7.12 Violations of the Act or an order or regulation made there-
under are punishable on summary conviction.^{16/} This extends to every
Exchange officer responsible should the Exchange fail to comply.^{17/}
Obstruction of the Supervisor in the performance of his duties by any
officer or employee of the Exchange or Clearing corporation is an offence.^{18/}

Extension to Other Exchanges

7.13 Section 2(2) of the Act empowers the Governor-in-Council to
extend the provisions of the Act to any grain exchange in Canada, its
officers, members and related clearing house where trading is conducted
by reference to grades established under The Canada Grain Act upon being
satisfied:

"...that the principal part of the grain dealt in by
means of contracts made on such exchange is shipped
out of the province of production, or is exported
from Canada, and that the transactions in grain on
such exchange are transactions in inter-provincial
or international trade, and that the national inter-
ests of Canada are affected by such transactions."

Status of the Act Following Proclamation

7.14 The Second World War intervened and on September 27th, 1943,
by order-in-council, futures trading in wheat was suspended. The Canadian
Wheat Board was constituted the sole interprovincial and international
marketing agency for western Canadian wheat. Following the War the Wheat
Board's exclusive power as marketing agency for wheat grown in a designated
area comprising Manitoba, Saskatchewan, Alberta, the eastern edge of
British Columbia and the western edge of Ontario was outlined and confirmed.

16. Sections 12 and 13.

17. Section 14.

18. Section 15.

In 1949, the Wheat Board's power was extended to oats and barley with control over the delivery of grain into elevators and railway cars in the designated area. Wheat, oats or barley to be consumed outside the province of production had to be sold to the Canadian Wheat Board. Dealers, processors and exporters, were required to purchase these grains from the Wheat Board.

Rapeseed Plebiscite, 1973

7.15 The winter of 1973 saw a plebiscite conducted among prairie farmers on behalf of the federal government to determine whether they wished the Canadian Wheat Board to take monopoly control of rapeseed marketing. The vote favoured an open market.

Feed Grains Policy, 1974

7.16 In June, 1974, the federal government announced a policy that as of August 1st, 1974, timed for the current year's harvest, western wheat, oats and barley for domestic animal feed use might be bought and sold in any part of Canada without restriction at prices determined by the market and without the intervention of the Canadian Wheat Board. Thus there is now a free market for western feed wheat, oats and barley for domestic animal feed use for which the Winnipeg Commodity Exchange provides futures trading facilities.

Implementation of the Grain Futures Act, 1939

7.17 At the time of the rapeseed plebiscite the Right Honourable Otto Lang, the federal Minister of Justice and Attorney General for Canada and the minister responsible for the Canadian Wheat Board, stated that the result of the plebiscite committed the federal government to the implementation of the Grain Futures Act of 1939. This committee was informed that the Act was being reviewed by appropriate officials with a view to updating

it to meet contemporary needs. Apart from Mr. Lang's pronouncement there has been no definitive statement as to the federal government's intentions and priorities.^{19/}

7.18 To illustrate the changes which might be proposed it is to be noted that when the Act was conceived the commodities upon which futures contracts were traded on the Winnipeg Exchange were exclusively agricultural field crops. Even within the agricultural sphere the Act did not include rapeseed, an extremely important crop, which was introduced on the Exchange in 1963. The Winnipeg Commodity Exchange, reflecting the change in name, now also trades in gold bullion futures.^{20/} The introduction of contracts for other non-agricultural commodities is under active consideration.

7.19 The Committee's limited information is that when a federal government decision is made to implement the Act it would be followed immediately by the appointment of a Supervisor to observe futures trading in Winnipeg with a view to extending the list of regulated commodities. However, the question may be raised as to the appropriateness of a regulatory authority having exclusively agricultural connections. In the United States it was decided to establish a fully independent Commodity Futures

19. It should be noted that while the federal government does not presently supervise trading on the Winnipeg Commodity Exchange it does exercise control over key documents in the trading process. The registered warehouse receipts on grains deliverable under its futures contracts are guaranteed by a federal agency, the Canadian Grain Commission, and the gold deposit certificates issued on bullion deliverable under the Exchange's gold bullion futures contracts have had to be designed so as not to be a subsidiary currency and thereby offend against the federal government's exclusive jurisdiction over currency and the issuance of paper money under heads 14 and 15 of Section 91, The British North America Act.

20. The Exchange also introduced futures contracts in Maritime potatoes and live beef in the late 1960's but trading in these contracts has since been terminated, in the latter, except for liquidation orders, as of January 20, 1975.

Trading Commission able to avail itself of the expertise of the Department of Agriculture but not bound by it.

7.20 It may be the conclusion that the immediate goal in implementing the federal Act would be to relieve the Western farmers of any suspicions they may entertain about the Winnipeg Exchange. One of our Committee members, Dr. Thomas P. Mohide, then associated with the Winnipeg Exchange as its President, submitted Notes on the Possible Implementation of the Grain Futures Act, 1939. There, he stated in effect, that apart from the generation of confidence in the futures markets hoped to be achieved through the regulatory presence of the Canadian Grain Commission^{21/} and a Supervisor who will assure conformity with proper trading practices, investigate and correct, when substantiated, charges of manipulation and price fixing, and be in a position to dampen excessive speculation and look into complaints from members of the public, other suggested benefits would be, inter alia: the more willing provision of information concerning the extent and character of members' transactions to a government agency than to Exchange officers and staff because of the fear of possible disclosure to competitors, the publication of statistics derived from information obtained together with data otherwise in the hands of government agencies to assist in formulating future production plans and storage and movement strategies and to further the study and identification of the causes of price spreads.

7.21 The Canadian Grain Commission, an agency of the federal government headquartered in Winnipeg, is well respected by Western producers and in all quarters of the grain trade as an impartial and effective agency cognizant of Western concerns as was its predecessor, the Board of Grain Commissioners (B.G.C.), in 1939. The question is raised, however, as to their willingness to direct their attentions to the broader strategies involved should the Act be extended to all commodities as was done in the United States.

21. Formerly the Board of Grain Commissioners.

Provincial Concerns as to Federal Regulation

7.22 There are policy implications in federal regulation which we are now merely touching upon. The constitutional boundaries allocated to the federal government and the provinces under The British North America Act are under close review in many areas. The law is not settled. The jurisdiction of the provinces concerning the production and marketing of natural resources including agricultural products within their boundaries are actively under discussion.

7.23 The principal recommendations in the next Chapter are directed to the registration or licensing of those permitted to trade in the province in commodity futures contracts or options based upon commodity futures. While we recommend the establishment of a framework for the regulation of commodity exchanges which might be established in the future within the province we do so in the context of a regional market place, the regulation of contracts, the establishment of a regulatory framework within which people may move and contract in the auction "pit" or "ring" with confidence. In brief, both with respect to the recommendations as to registration and the rules respecting the establishment of a commodity exchange, the legislation is directed to consumer protection - to the protection of the individual investor. In the end result the person whom we seek to protect is likely to be, in the language of this market, the speculator and not the hedger - the relatively small investor whose many trades provide liquidity and stability to the market place and aid in the primary objective namely, to provide a facility for the hedger.

CHAPTER VIII

CONCLUSIONS AND RECOMMENDATIONS

A. CONCLUSIONS

The Need for and Purpose of Regulation in Ontario

8.01 There are three principal areas to which attention must be directed in considering the need for regulation of trading in commodity futures contracts and other contracts or agreements based on the present or future price of commodities. These are:

- (a) the contracts;
- (b) the market place; and
- (c) the participants.

As regards (a) we have considered these in Chapter II, IV and V. In Chapter II we examined the market place, its participants and the economic functions of commodity futures trading. The three elements are ingredients in all of the preceding chapters.

Registration: The Participants

8.02 Turning, firstly, to the participants, our prime concern is for the small speculator. We have noted that the commodity futures market is an arena for sophisticated hedgers and speculators. The small speculator must be served by honest, competent and financially sound dealers and advisers. Despite the complete lack of regulation in the commodities field the public is fortunate to have available some persons who because they are registered to deal in and advise concerning securities under The Securities Act (Ontario) have received a regulatory screening designed to establish their honesty and generally good reputation. As professionals, some of them have established a capacity to service their clients by advice and

through execution of orders in the commodity futures market. There are also persons, offering their services as dealers and advisers, who have not been subject to such a screening. Some of them would have no problem in meeting minimum regulatory requirements. The worst of them, as has been demonstrated by two recent prosecutions, have engaged in fraud.^{1/}

8.03 The briefs submitted to the Committee generally supported a licensing scheme. The only publicly dissenting voice noted by the Committee, and that through the financial press, was an individual whose method of collecting debts was the subject of public comment shortly afterward. The Committee has reviewed regulatory schemes in other jurisdictions, existing and proposed, and through our recommendations have selected those elements which we believe are appropriate for Ontario.

The Market Place

8.04 Many of the abuses to which legislation is directed take place in the market place. In the United States all commodity futures exchanges will now be subject to newly extended federal legislation.^{2/} In Canada the Winnipeg Commodity Exchange is self-regulated by its members. However, federal legislation is in place awaiting to be implemented.^{3/}

8.05 Commodity exchanges exist to fill an economic need. They cannot be regulated into existence.^{4/} However, the Committee believes it

1. Regina v. John Vance (Unreported trial before His Honour Judge Honsberger, County Court. Conviction registered September 10, 1974); Regina v. Thomas Boyle (Unreported trial before His Honour Judge Rice, Provincial Court, Criminal Division. Conviction registered September 20, 1974).
2. Supra. Chapter VI.
3. Supra. Chapter VII.
4. As a point of interest we note the officers of the Montreal Stock Exchange are also officers of a presently dormant Montreal Commodity Exchange.

appropriate to include in any proposed legislation a regulatory framework within which an exchange could be established and supervised in Ontario.

8.06 We anticipate that recognition of any Ontario commodity exchange under the legislation would depend on its compliance with general government policies regarding self-regulatory bodies. For instance, The Toronto Stock Exchange was incorporated through a public Act of the Legislature with a requirement that it have a minimum of two public governors whose names must be approved prior to nomination by the Lieutenant-Governor in Council.

8.07 In the course of this report^{5/} we have touched on the kinds of frauds found in commodity futures markets, in particular "bucketing" or gaming in commodities, dissemination of false, misleading or inaccurate market information to affect commodity futures prices and "wash" trading through an exchange to create a fictitious appearance of public market activity. We have not addressed ourselves to changes which might become necessary to The Criminal Code (Canada). Committee Member Then is a member of the Attorney General's staff. He will be reporting directly to his Ministry as to this aspect of the study. Suffice it to say that, with the exception of "wash" trading, The Criminal Code as presently framed appears to adequately cover the classes of crimes considered and provided for by the draftsmen of the new U.S. legislation.^{6/}

The Contracts

8.08 While the border line between those types of contracts we have discussed in the preceding chapters which would be more appropriately regulated as securities and those which should be the subject matter of the new legislation recommended in this report may be blurred we have attempted

5. Supra. Chapter I, para. 1.04, footnote 13; Chapter VI, paras. 6.36 6.39, 6.40 and 6.41, footnotes 54, 64 and 68.

6. See Chapter VI.

to apply an objective test to make the distinction.

8.09 Where the contract is a commodity futures contract^{7/} or a commodity futures option^{8/} traded on an established exchange and carrying the collateral guarantee of a clearing house it clearly falls within the scope of the proposed legislation as being the type of contract for which the regulatory tools and techniques designed for the protection of investors in securities are not wholly suitable. On the other hand, those contracts we have examined which are of the nature of investment contracts where the investor is directly at risk with the grantor or writer of the contract should be governed under The Securities Act. These are:

- (a) commodity futures options not guaranteed by the clearing house of an established exchange and those commodity futures options not "accepted" for trading under the proposed new legislation;
- (b) coin dealers' margin account contracts^{9/} and their like;
- (c) options on physical commodities^{10/} offered to other than producers, dealers or users of the particular commodity.

These issuers must be prepared to file a prospectus under The Securities Act which would be delivered to the proposed purchaser giving a detailed account of his affairs, the nature and risks inherent in the investment, and the ability of the issuer to meet his commitments. Through the prospectus screening process the O.S.C. would be obliged to refuse to accept the prospectus for filing where the latter capacity is not demonstrated.

7. Supra. Chapter II

8. Supra. Chapter IV

9. Supra. Chapter V

10. Supra. Chapter IV, para. 4.23.

8.10 To achieve this end the definition of "security" in The Securities Act should be amended to specifically encompass all of the commodity related contracts we have suggested should be regulated under that Act.

8.11 We have concluded the definitions and exemptions in the proposed legislation and The Securities Act should be framed so as to exclude, for greater certainty and clarity, bona fide hedging transactions^{11/} through commodity futures contracts, commodity futures options and commodity options, all spot commodity transactions and forward contracts entered into by bona fide hedgers.

8.12 We have concluded that trading in certain options should be prohibited on the ground that they are without any utility and have been demonstrated to be probable vehicles for fraud. Options to buy commodities ("calls") should be prohibited unless their performance is guaranteed by a "recognized" commodity exchange or clearing house or the option grantor has a demonstrated present and continuing ability to meet the obligation to deliver the physical commodities called for under the contract. Similarly options to sell commodities ("puts") should be prohibited unless their performance is guaranteed by a "recognized" commodity exchange or clearing house or the option grantor has a demonstrated present and continuing ability to meet the obligation to purchase the physical commodities in accordance with the contract.

11. The definition of "bona fide hedging transactions" should be an appropriate modification of the definitions found in the Grain Futures Act, 1939 (Canada) (supra. Chapter VIII, para 7.07) and the U.S. Federal Commodity Exchange Act (supra. Chapter VI, footnote 58). Consideration should also be given to the results of the forthcoming redefinition of the term in the latter Act (See supra. Chapter VI, Footnote 58 at page 63).

8.13 We have concluded that, except for bona fide hedging transactions, only those commodity futures contracts,

(a) traded on a commodity exchange "recognized" by the regulatory authority responsible for administration of the proposed new legislation; and

(b) "accepted" by that regulatory authority should be permitted to be traded in Ontario. A necessary prerequisite to "recognition" of a commodity exchange would be that the commodity futures contracts traded on its floor carry the collateral guarantee of a clearing house.

8.14 While the existence of governmental regulation of the exchange will be an important factor in granting "recognition", the lack of present government supervision should not, for example, prevent the recognition of the Winnipeg Commodity Exchange.

8.15 Where regulation by government is absent the kinds of safeguards which exist and are being extended under the U.S. federal Commodity Exchange Act^{12/} are likely to be lacking. European commodity exchanges, for example, are not required to publish figures on daily volume and open interest considered by the Committee as critical data in reaching investment decisions.

8.16 Once a commodity exchange has secured "recognition"^{13/} then the kinds of commodity futures contracts traded on that exchange should be submitted to, and "accepted" for trading in Ontario by, the regulatory authority. At this point such factors as the contract terms and the exchange imposed margin and limit requirements would be reviewed to determine if the contract is acceptable.

12. Discussed in detail supra. Chapter VI.

13. It is anticipated that applications would be made by or on behalf of each exchange in a manner similar to the application made to the Ontario Securities Commission during the fall of 1974 by the Chicago Board Options Exchange under Section 20 of The Securities Act.

8.17 Where a "recognized" exchange provides facilities for trading in commodity futures options which are also guaranteed by a clearing house the exchange may request "acceptance" of such option contracts. It should be a condition precedent that the commodity futures contract underlying the option must first be "accepted". If "acceptance" is not obtained trading in such commodity futures options, except for bona fide hedging transactions, would not be permitted in Ontario except as a security under The Securities Act. The definition of security in The Securities Act should be amended to reflect this position.

8.18 To recapitulate our conclusions as to the appropriate division of jurisdiction over commodity related contracts between the proposed legislation and The Securities Act, except for bona fide hedging transactions only commodity futures contracts traded on an exchange "recognized" by the regulatory authority under the proposed new legislation and "accepted" by that authority would be permitted to be traded in Ontario. A "recognized" exchange may also seek "acceptance" of commodity futures options guaranteed by its clearing house. If not "accepted" such commodity futures options would be classed as securities under The Securities Act and, except for bona fide hedging transactions, could not be traded without a prospectus under that Act.

8.19 Dealt with as securities under The Securities Act would be, as well, commodity futures options not guaranteed by any clearing house, margin account type contracts, and options on physical commodities. Trades in these securities to bona fide hedgers should be exempted from registration and prospectus filing requirements.

Constitutionality of Proposed Regulation

8.20 We have had the benefit of the opinion recently prepared by the Deputy Attorney General for the Minister of Consumer and Commercial Relations regarding proposed federal regulation of mutual funds and are of the view that, on the basis of the law outlined in that opinion, our proposals are within the competence of the Legislature.

B. RECOMMENDATIONS: PROPOSED COMMODITY FUTURES LEGISLATION

Regulatory Body: Commodity Commission or Ontario Securities Commission

8.21 Three briefs, including that of the Investment Dealers Association of Canada, recommended regulation of commodity futures trading through a separate Ontario Commodity Futures Commission. The Ontario Securities Commission itself recognized that The Securities Act was not the vehicle to bring this type of trading under regulation. However, it is questionable that the size and scope of the problem, particularly in the absence of a commodity exchange in Ontario coupled with the fact that much of the trading is presently done by existing securities dealers, warrants a completely new bureaucracy.

8.22 We have concluded that the task of establishing and supervising this regulatory scheme and administering the new legislation should be given to the Ontario Securities Commission, utilizing, so far as possible, their present staff. The proposed legislation involves a scheme of registration and supervision. Many of the potential registrants and advisers presently hold registration from the Ontario Securities Commission as securities dealers and salesmen. The Commission has in place administrative machinery which, it might be suggested in light of the existing securities market, has the capacity to undertake additional licensing tasks.

8.23 Except for such experience as has been achieved through this study, the Commission is still without staff that has specific expertise in the commodities field. It is suggested that this deficiency might be corrected in two ways. Firstly, as to the Commission itself, except for the Vice-Chairman and Commissioner Steiner, who have had some considerable experience in the regulatory and business aspects of the securities field, each of the present Commissioners, including the Chairman, came to the Commission because of particular expertise or experience not directly connected with the securities business. Their experience in the field has been

achieved as Commissioners. The Chairman is a barrister with some considerable business experience, Commissioner Guillet is an engineer, Commissioner Hutchison was a senior partner of a major accounting firm with broad business experience while Dean Johnston and Professor Beck are academics with special interests in the commercial law field. Any lack of commodity expertise could be met through the appointment of an additional Commissioner with such experience. Secondly, at the administrative level an individual should be sought with experience in the commodity field to head that program and assume the post, Deputy Director, Commodity Futures Regulation. He would give guidance and direction to the registration and surveillance program and, indeed, would be responsible for the initial registration program. Policy and procedures would be developed by, or under the direction of, these two proposed commodity specialists.

8.24 This program could be undertaken with a minimum expansion of staff. In the absence of a commodity exchange in Ontario there is no immediate need for staff to regulate this area. Through the "recognition" of commodity exchange we must rely on the regulations in force on the "recognized" exchanges. In the case of a suspected fraud effected from Ontario through the Winnipeg Commodity Exchange investigation could be carried out through direct contact with the Commercial Fraud Section of the Royal Canadian Mounted Police by the Commission's investigation staff and, as in the past, the assistance of the Manitoba Securities Commission and other Provincial securities administrators.

8.25 To duplicate the administrative machinery available through the Ontario Securities Commission's existing registration program would seem wasteful. The Commission and its Director would be charged with the administration of the new Act. The Director would be assisted by his specialist, the Deputy Director, Commodities Futures Regulation.

Commodity Futures Advisory Board

8.26 We recommend that the Commission should have available for consultation a body styled the Commodity Futures Advisory Board. Its role would be similar to the Financial Disclosure Advisory Board the Commission has available as its advisor on financial disclosure matters under The Securities Act. The Commodity Futures Advisory Board consisting of five members with varying experience in the field appointed by the Lieutenant-Governor in Council would advise the Ontario Securities Commission in matters of policy and planning as well as on specific questions referred to it by the Commission. Its members would be persons of recognized expertise. This might include senior members from other Ministries having a concern for the impact of commodity futures trading on the economic life of this Province and persons from industry.

"Contract": Definition

8.27 "Contract" as defined in the new Act should include commodity futures contracts and commodity futures options only where the latter are traded on a commodity exchange and guaranteed by that exchange's associated clearing house.

8.28 "Commodity" should be defined to include such primary, fungible commodities, whether in their original or a processed state, as agricultural products, forest products, products of the sea, minerals, metals, hydro-carbon fuels, precious stones and other gems, currencies and other goods and articles commonly known as commodities.

8.29 "Commodity futures contract" would mean a contract whereunder the parties agree to make or take delivery of a specified quantity and quality or grade of a commodity during a designated future delivery month at a price agreed upon when the contract is executed upon a commodity exchange pursuant to standardized conditions and terms set forth in its by-laws, rules or regulations.

8.30 "Commodity futures option" would mean an option on a commodity futures contract.

"Recognition" of Exchanges: "Acceptance" of Contracts

8.31 As outlined at paragraphs 8.13 to 8.17 in determining whether a particular class of contract can be traded in Ontario to other than bona fide hedgers two steps will be necessary. Firstly, an application will be required to be made to the Ontario Securities Commission for "recognition" of a particular commodity exchange. If that exchange is "recognized" then application can be made to have contracts traded on that "recognized" exchange "accepted" for trading in Ontario.

8.32 Application for "recognition" should be made to the Commission itself. This is an important responsibility which should be dealt with at the senior level. The applicant should satisfy the Commission that conditions similar to those which would be required for the recognition of an Ontario commodity exchange exist. ^{14/} There would also be a review of any regulation imposed by other governmental authorities.

8.33 The contracts traded or proposed to be traded on "recognized" exchanges should be "accepted" on behalf of the Commission by the Director, in practice the new Deputy Director, Commodity Futures Regulation.

Exemption

8.34 Exemption would be provided from the requirement that contracts be "accepted" where the issuer of a commodity futures option has filed, and obtained a receipt for a prospectus under The Securities Act.

Classes of Registrants

8.35 There should be a general prohibition against trading in contracts, engaging in the business of advising others as to the investing in or buying or selling of contracts, or acting as a floor broker without registration.

14. Infra. para. 8.78

8.36 There should be a further prohibition against acting as a commodity exchange in Ontario without written permission from the Commission.

8.37 The following defined classes of registration should be provided for:

- (a) commodity futures dealers; ^{15/} their partners, officers and salesmen;
- (b) management companies ^{16/} and portfolio managers; ^{17/}
- (c) commodity futures advisers; ^{18/} and individuals actually furnishing the direct advice to clients, e.g. partners, officers and designated advisers;
- (d) floor brokers ^{19/} and their floor traders.

8.38 Registration should be required for a member of a commodity exchange even though he trades on that exchange solely for his own account in order to insure his honesty and good reputation.

Exemptions from Registration

8.39 In the case of commodity futures dealers, employees acting solely in a clerical or administrative capacity would not have to be registered.

8.40 Management companies and portfolio managers registered, or

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- 15. "Commodity futures dealer" would mean a person or company that trades in contracts in the capacity of principal or agent.
 - 16. "Management company" would mean a person or company that provides investment advice with respect to contracts under a management agreement.

"Management agreement" would mean an agreement under which an issuer as defined in Bill 75, The Securities Act, 1974 is provided with investment advice with respect to contracts, alone or together with administrative or management services, for valuable consideration.
 - 17. "Portfolio manager" would mean a person or company engaging in or holding himself or itself out as engaging in the business of managing the investment portfolio of clients through discretionary authority granted by the client to purchase and sell contracts for the account of that client.
 - 18. "Commodity futures adviser" would mean a person or company engaging in or holding himself or itself out as engaging in the business of advising others as to the investing in or the buying or selling of contracts.
 - 19. "Floor broker" would mean any person who, on any commodity exchange buys or sells for any other person any contract.

exempted from registration, under The Securities Act would not be required to be registered under the proposed commodity futures legislation.

8.41 With respect to commodity futures advisors, where the performance of the service is solely incidental to their principal business or occupation, registration as an adviser would not be required for,

- (a) a bank or an Ontario registered trust company or Ontario licensed insurance company;
- (b) a lawyer, accountant, engineer or teacher;
- (c) a person or company registered for trading in contracts;
- (d) a publisher or writer for a bona fide newspaper, news magazine or business or financial publication of general and regular paid circulation distributed only to subscribers or purchasers for value, who gives advice only through such publication and has no interest directly or indirectly in any of the contracts concerning which advice is given and receives no commission for giving the advice;
- (e) such other persons or companies as are designated by the regulations.

8.42 Registration would not be required with respect to a trade by a person or company acting solely through an agent who is a registered commodity futures dealer.

Conditions of Registration

8.43 While the Director should be given the general power to prescribe additional conditions of registration specific power should be included in the Act to permit the making of regulations by the Lieutenant-Governor in Council covering the subjects enumerated below which are not dealt with in the Act itself.

(1) Educational and Experience Standards

8.44 Minimum educational and experience requirements should be

established for each class and category of registrant. The Canadian Securities Institute, which has provided courses and examinations for most categories of securities registrants, has been approached and has commenced preliminary enquiries in this area. There are established courses in existence in the United States. The Committee sees no problem in establishing such minimum standards.

(2) Non-Resident Ownership

8.45 Declared government policy for securities dealers is to prohibit new registrations where the non-resident interest in the firm exceeds 10% with respect to any one non-resident person or company and 25% in total. The object of such restrictions, as was explored in depth in the Report of the Securities Industry Ownership Committee of the Ontario Securities Commission^{20/} was to encourage and support a Canadian owned dealer community responsive to the needs of Canada. Many of the same considerations apply to commodity futures dealers and advisers. It is such dealers who band together for the purpose of establishing a commodity exchange. If these principles apply we recommend that "grandfather" recognition be given to dealers and advisers whose ownership exceeds the 25% limit on or prior to March 1, 1975. They must be established and actively conducting business as of that date.

8.46 It is essential that even the non-resident owned firms be conducted through a federally or provincially incorporated subsidiary within a reasonable time of the coming into force of the proposed legislation. The proposed regulation is directed exclusively to the dealer-adviser and not to the commodity exchanges. It is important that the regulatory authority have some effective focus of supervision rather than having to deal with foreign owned branch offices.

8.47 Some concern was evidenced in the Committee that the exclusion

20. Ontario Securities Commission, April, 1972.

of foreign owned firms, members of one or more commodity exchanges, might result in some reluctance on the part of those exchanges to accept Canadian owned firms as members. However, we are informed that unlike the practice prevailing on some stock exchanges there are no restrictions based on ownership on most of the commodity exchanges in the United States.

(3) Records and Reports

8.48 Dealers, advisers and floor traders should be required to maintain and make available for examination by persons appointed by the Commission records and books of accounts appropriate to the category of business in which they are engaged.

8.49 Regular financial reports in prescribed form will be required of dealers and advisers, except where there is a self-regulatory body recognized by the Commission, in which case the reports will be made initially to that organization's auditor whose appointment would be subject to Commission approval.

8.50 Audit and basic record making and keeping requirements, including provision of recognition for self-regulatory bodies, should be set out in the Act.

8.51 Each dealer or adviser will be subject to inspection and shall produce such trading information as required from time to time under the regulations or by order of the Commission. The power of the Commission to require special reports should be included in the Act.

(4) Confirmations: Statements of Account

8.52 The Act should provide for the form of confirmation required to be furnished to the client as proof of the contract, and the details of purchase.

8.53 The confirmation should contain a clear statement concerning the obligations to provide maintenance margin and the result of failure to do so.

(5) Minimum Capital Requirements

8.54 Since commodity futures markets are subject to wide fluctuations and the dealer is responsible for furnishing maintenance margin to his clearing member further study should be given as to the minimum free capital which each class of registrant should have. Certainly, in the case of commodity futures dealers it should be no less than the \$25,000 net free capital required for securities dealers, subject to upward adjustment as the volume of business increases. The minimum net free capital for dealers will be calculated so that it provides a cushion over and above a reserve required to meet margin calls. The method of computation can be readily established. Liabilities incurred through commodity futures transactions are presently taken into account in computing the net free capital for securities dealers who are engaged in trading commodity futures contracts. The Toronto Stock Exchange requires specific reports from them.

8.55 Management companies and portfolio managers should be required to maintain minimum working capital of \$25,000. Advisers should be required to have a minimum working capital of \$5,000.

(6) Bonding and Insurance

8.56 Bonding or insurance for dealers, management companies and portfolio managers, protecting against employee negligence or fraud and mysterious defaults should be, as with a securities dealer, for not less than \$200,000, and scaled up according to the volume and value of business. In the case of an adviser the minimum coverage should be \$10,000.

(7) Contingency or Compensation Funds

8.57 It is recommended that all dealers be required to participate in either a contingency trust fund established by a trustee with the approval of the Commission or, in the case of members of a recognized self-regulatory organization, a parallel contingency trust fund or compensation funds established by the self-regulatory body for the protection of the

clients of insolvent dealers. It would be contemplated that the contingency trusts established would be in terms identical with those provided for in the regulations to The Securities Act, participation being a condition of registration. The participating contribution to the contingency trust fund, now \$10,000, is considered part of the participant's capital.

8.58 Based upon the Committee's enquiries, it is by no means certain that the Board of Governors of the National Contingency Fund established in 1969 by the Canadian stock exchanges and the Investment Dealers Association of Canada would meet the claims of clients of a defaulting dealer where the claim arose from commodity futures transactions. No doubt this point would be resolved by the members of the Fund as it would be one of the criteria for recognition of existing self-regulatory bodies such as The Toronto Stock Exchange and the Investment Dealers Association of Canada under the proposed commodity futures legislation if these organizations wish to undertake new responsibilities in this area.

(8) Minimum Margin Requirements

8.59 The regulations should require the dealer to obtain from a client payment of not less than the minimum original margin and maintenance margin required by the commodity exchange upon which the contract is traded, or such higher minimum margin requirements as may be from time to time fixed by the Commission with respect to such contracts.

8.60 The dealer should be free to impose additional margin requirements upon the client to protect himself.

(9) Segregation of Funds

8.61 The Act should provide that all margin payments and all funds accruing to the customer should be separately accounted for. They should not be commingled with the funds of the dealer or be used to margin the trades or contracts or to secure or extend the credit of any customer other than the customer for whom the funds are held. The Act should design-

nate such funds as trust funds for the benefit of the clients for whom they are held. These classes of contract obligations are quite different to the purchase of securities. This type of liquidity and protection is essential.

8.62 Margin and funds accruing in connection with the customers' accounts may be kept in a single trust fund. The prohibition against commingling the dealer's funds with the clients' funds shall not be construed as preventing the dealer from having a residual financial interest in the trust funds nor preventing the dealer from lending clients sufficient funds from time to time so as to prevent the clients' accounts from becoming undermargined.

(10) Commission Rates

8.63 Commission rates charged by Ontario commodity futures dealers vary from dealer to dealer. This reflects the addition of surcharges to the minimum commission levels set by the commodity exchanges in Winnipeg, the United States and the United Kingdom. Such a surcharge is necessary for the firm to obtain a fee and thus a profit where it is not a member of the exchange on which the trade is effected.

8.64 At least one brief recommended that commission rates should be standardized, presumably by regulatory rule. The Committee does not recommend such action. Apart from some general authority in the Commission to intervene where the commissions and other fees charged appear unconscionable for the services provided, which might appear in the Act, the client must make his own enquiries concerning an individual firm's commission rates.

8.65 It has been suggested that the Commission might consider making the charges levied by each dealer a matter of public record for inspection of potential clients. It is difficult to accept this proposition since it would encourage some belief that the service offered by each firm is equal. The information statement recommended in paragraph 8.71.

should contain a clear statement as to the commissions charged by that dealer.

(11) Advertising: Prohibited Representations

8.66 We recommend that certain representations (similar to those contained in The Securities Act) concerning the future value of the commodity underlying the contract traded, refunding margin or assuming the obligation under the contract should be prohibited.

8.67 Dealers and advisers should be required in the Act to disclose whether they have an interest, direct or indirect, and whether it is net short or net long in any class of contract recommended.

8.68 We do not recommend that the Commission be required to review or approve dealer or adviser advertising or other sales literature although it may be felt helpful during the initial period to request registrants to file copies of all literature with the Commission for its perusal at the time it is proposed to use it. This would enable the Commission to develop some views particularly as to whether the circumstances indicated in paragraph 8.69 exist.

8.69 Where the Commission is of the opinion, after holding a hearing, that the registrant's sales literature appears to require review the Commission should have the power to require that it be submitted to the Director for review and approval before use.

(12) Suitability of Investment Standards:
Know Your Client Rules

8.70 Trading in commodity futures is not for amateurs. Either the client or his adviser must be knowledgeable and competent. Because of its volatility and highly speculative nature commodity futures trading exposes

the client to the risk of incurring substantial losses, sometimes in a matter of minutes. Because of the leverage involved the exposure to loss is much greater than in a securities transaction.^{21/} The Committee, therefore, recommends that the regulations provide for "know your client" standards to be applied when the client first opens an account. This should include obtaining basic information concerning the knowledge, experience and financial capacity of the client. Based upon this information the dealer will have means of assessing the suitability of a particular investment for the client, an obligation the dealer should have when making recommendations or offering advice to the client.

8.71 The Committee recommends that the dealer be obliged, at the time each new account is opened, to furnish the client with a written statement, containing information prescribed by the regulations under the Act, which will explain in simple terms the nature of, and the risks inherent in, commodity futures trading, the nature of the contracts themselves and the obligations assumed by the customer upon entering a contract. The statement should advise him to request and study the terms and conditions of the contracts traded on the particular exchange and not merely rely on the summary outline pamphlets frequently issued by the exchanges. The statement will also furnish details concerning commissions and other service charges levied by that dealer.

8.72 The Act should make it a term and condition of "recognition" of a commodity exchange's contracts for trading in Ontario that the exchange furnish, on request, copies of all of the terms and conditions of the contract. The "recognized" exchange should be obliged to designate an Ontario agent through whom it would supply copies of the contracts to other Ontario registrants and their clients.

21. See supra. Chapter III, para. 3.23

(13) Refusal, Suspension or Cancellation
of Registration

8.73 The Act should grant the Director the power to refuse registration, after hearing, or grant registration subject to terms and conditions. The Director will have no power to grant registration until he is satisfied that the conditions of registration stipulated in the regulations are met.

8.74 Power to suspend, cancel, restrict or continue registration on terms and conditions should be vested in the Commission. Except where the delay is considered prejudicial to the public interest the Commission shall not take action without first holding a hearing. In the emergency situation the hearing must be convened within fifteen days of the suspension.

8.75 The Act should detail the necessary administrative hearing procedures.

(14) Withdrawal of "Recognition" and "Acceptance"

8.76 At paragraphs 8.13 to 8.17 and 8.31 to 8.33 we discussed "recognition" of exchanges and "acceptance" of contracts. The Act should give the Commission the right, subject to an obligation to hold a hearing within fifteen days of any temporary order, to withdraw "acceptance" generally of all contracts traded on a particular exchange by withdrawal of "recognition" of the exchange or to suspend trading in a particular contract or contracts by withdrawal of "acceptance" of the contract or contracts. This action would be based upon factors relating to the underlying commodity, e.g. lack of current information, or, on factors respecting the particular exchange or clearing house. The latter would include the capital resources of the exchange and clearing house, the reasonableness of margin requirements, the fairness of floor trading practices including the extent of their supervision, the adequacy of the measures taken by the exchange to prevent excessive speculation, manipulation,

corners and squeezes, the terms of the contract with special regard to the designation of delivery points and the integrity of warehouse receipts, and the nature of the government regulation to which the exchange is subject. Once "acceptance" of contracts is withdrawn only liquidating trades would be permitted.

(15) Powers of Investigation

8.77 The Commission should have the power to appoint investigators who, in turn, would have the power to conduct effective investigations into trading in contracts or other matters necessary for the proper administration and enforcement of the Act. These requirements would be patterned on those found in other consumer protection legislation.

Establishment, Recognition and Supervision of Ontario Commodity Exchanges

8.78 The Act should lay the groundwork for the establishment of commodity exchanges and their supervision by the Commission. An outline of the legislation recommended is as follows:

- (1) The Act should contain a general prohibition against any person or company carrying on business as a commodity exchange without the written consent of the Commission.
- (2) The Act will require the Commission, where it is of the opinion that to do so would not otherwise be prejudicial to the public interest, to issue its consent where it is satisfied that the commodity exchange has satisfied or can satisfy all the conditions stipulated in the regulations for the conduct of the business of a commodity exchange.
- (3) The regulations will require the exchange to submit its proposed by-laws, regulations, rules and policies to the Commission for approval and, where there is an associated clearing house, the proposed by-laws, regulations and policies of the clearing house.
- (4) The regulations will require the Commission to be satisfied as to the capital resources of the exchange and its clearing house, the reasonableness of its margin requirements, the fairness of the floor trading practices and the extent of their supervision, the adequacy of the measures proposed to be taken by the exchange to prevent excessive

speculation, manipulations, corners and squeezes, the nature and terms of the contracts and the steps taken to assure their performance, the rules and regulations applicable to clearing members, exchange members and floor traders, and like matters along the line of the standards established in the newly amended United States legislation.

- (5) The Act should require the exchange to keep a record showing the time at which each transaction took place and to furnish the customer of any member, upon production of the written confirmation of any transaction with such member, particulars of the time at which the transaction took place and verification or otherwise of the facts set out in the confirmation. This is to enable the customer to consider whether he has been fairly dealt with and the Commission to investigate.
- (6) The Commission should be satisfied that the exchange has made provision to record and publish details of trading as it occurs on a timely basis and to produce not later than one hour before the opening of the next day's trading a summary of all futures and cash transactions which occurred the previous trading day including a statement of the open interest. The exchange should facilitate the dissemination of facts concerning the commodities underlying its contracts.
- (7) To curb excessive speculation the Act would grant the Commission power to fix margins and speculative limits, except for bona fide hedging transactions. The Commission, in order to monitor the level of speculative activity, should be given power in the Act to require daily trading reports from all dealers and any recognized exchange in Ontario.
- (8) The Act should give the Commission the same general powers, rights and duties as are found for the supervision of stock exchanges in The Securities Act.

Impact on Existing Marketing Authorities

8.79 We are of the view that the proposed legislation will have no impact on existing marketing authorities such as the Milk Marketing Board and the Egg Marketing Board and should not detract from the hedging mechanisms provided by the existing commodity futures markets.

APPENDIX "A"

TERMS OF REFERENCE INTERMINISTERIAL COMMODITY FUTURES STUDY COMMITTEE

PURPOSE

The purpose of this study is:

- (a) to establish the appropriate regulatory mechanisms to control and regulate trading in commodity futures in the Province of Ontario, in order to protect the customers of commodity futures brokers, and
- (b) to determine the desirability of encouraging the establishment of an exchange for the trading in commodity futures contracts in Ontario.

SCOPE

1. The study will cover all commodities whose futures can be traded, such as:
 - Agricultural products, as grain, meat, dairy products
 - Minerals, petroleum and their by-products
 - Forest products
 - Metals
 - Any other "Personal Property" whose futures can be traded.
2. The study shall focus on the question of licencing brokers and their salesmen dealing in commodity futures contracts, with particular emphasis on:
 - (i) "Fully backed" options on commodities, e.g. where delivery could be made by the "issuer" of the option.
 - (ii) "Naked" options, e.g. where the "issuer" has no present ability to deliver.
 - (iii) Licencing of Commodity Futures Brokers and salesmen, and their participation in trading through established Commodity Exchanges in the U.S.A., Canada or elsewhere.
3. The feasibility of establishing an Ontario Exchange shall be investigated and the nature and extent of possible federal participation in such an exchange shall be reviewed.

4. The question of the proper agency for administration and supervision shall be examined.
5. Regulatory practices in other jurisdictions (e.g. New York, California, Wisconsin) shall be reviewed.
6. The question of continuing to allow registered securities dealers to trade in futures shall be examined.

OUTPUT

The output of the study shall be recommendations regarding new legislation or amendments to existing legislation and/or regulations, plus recommendations regarding the nature, composition, organization and domicile of a regulatory body and mechanisms to control trading in commodity futures.

The impact of recommendations on existing bodies such as the Milk Marketing Board and the Egg Marketing Board, etc., shall also be explored.

APPENDIX "B"

INTERMINISTERIAL COMMODITY
FUTURES STUDY COMMITTEE

Members

Chairman

Harry S. Bray, Q.C.
-Ministry of Consumer
and Commercial Relations,
Vice Chairman, Ontario
Securities Commission

Martin J. Jaeger
-Ministry of Agriculture
and Food, Senior Econo-
mist, Policy Analysis
Section, Economics Branch

Dr. Thomas P. Mohide
-Ministry of Natural
Resources, Director,
Mineral Resources Branch
and Mine Assessor of
Ontario

David E. Redgrave
-Ministry of Treasury,
Economics and Inter-
governmental Affairs,
Executive Director,
Office of Economic
Policy

Dagmar A. Stafl
-Ministry of Consumer
and Commercial Relations,
Senior Economist

Edward F. Then
-Ministry of the Attorney
General, Counsel,
Criminal Appeals and
Special Prosecutions

Barry Tocher
-Ministry of Consumer
and Commercial Relations,
Management Officer,
Program Analysis

Study Director

Keith E. Boast, LL.B.

APPENDIX "C"

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APPENDIX "D"

ASSOCIATIONS, ORGANIZATIONS, FIRMS AND OTHER PERSONS FROM WHOM SUBMISSIONS WERE REQUESTED 1/

Auburn Commodity Services Inc.	
Bache and Co. Inc.	
Bakery Council of Canada	
Bank of Nova Scotia	
Board of Trade of Metropolitan Toronto	X
Broker Dealers Association of Ontario	
Canadian Cattlemen's Association	X
Canadian Feed Manufacturers Association	X
Canadian Food Processors Association	
Canadian Imperial Bank of Commerce	
Canadian Jewellers Association	
Canadian Livestock Feed Board	
Canadian Manufacturers Association	
Canadian National Millers Association	
Canadian Potato Chip Association	
Canadian Sugar Institute	
Christian Farmers Federation	
Clayton Brokerage Co.	
Consumers Association of Canada	
Engelhard Industries of Canada Ltd.	
Friedberg and Co. Ltd.	X
Grocery Products Manufacturers of Canada	
Handy and Harman of Canada Ltd.	
Investment Dealers' Association of Canada	X

1. X denotes formal submission contributed.

Johnson Matthey and Mallory Ltd.	X
Maple Leaf Mills Ltd.	
Meat Packers Council	
Merrill Lynch Royal Securities Ltd.	
National Farmers Union, Ontario Branch	
Ontario Beef Improvement Association	
Ontario Chicken Producers Marketing Board	
Ontario Egg Producers Marketing Board	
Ontario Farm Products Marketing Board	
Ontario Federation of Agriculture	
Ontario Flour Millers Association	
Ontario Food Council	
Ontario Food Processors Association	
Ontario Grain Corn Council	
Ontario Grain and Feed Dealers Association	
Ontario Institute of Professional Agrologists	
Ontario Milk Marketing Board	
Ontario Pork Producers Marketing Board	X
Ontario Soft Drink Association	
Ontario Turkey Producers Marketing Board	
Packers Trading Company	
Parrish and Heimbecker Ltd.	
Pollack and Company (1973)	
Richardson Securities of Canada	
Rosenthal Commodities	
Siegel Trading Co. of Canada Ltd.	X
Soyabean Growers Marketing Board	
Shulman, Morton, M.D., M.P.P.	X
Tea and Coffee Association of Canada	
Toronto Society of Financial Analysts	

Toronto Stock Exchange

Wheat Producers Marketing Board

The Winnipeg Commodity Exchange

APPENDIX "E"

SECTION 341 OF THE CRIMINAL CODE: THE SIGNIFICANCE OF THE "BUCKETING" PROVISION IN RELATION TO TRADE IN COMMODITIES.

by EDWARD F. THEN

It is often said that the key to the successful prosecution of fraudulent transactions or of those in the nature of fraud is not so much a knowledge of the applicable law but rather a thorough understanding of the factual basis of the transaction. This observation is pre-eminently true in the area of trading in commodities where the state of the law is by no means free from doubt and where the method of trading is diverse and complex.

Moreover, despite the long legislative history^{1/} of Section 341, there are remarkably few reported cases of prosecutions^{2/} under the Section. Fortunately, there have been many reported cases involving civil actions where Section 341 has been put forward as a defence, by either a broker or his client, on the basis that the contract entered into is unenforceable as an illegal contract because it contravenes the provisions of Section 341. The latter line of cases are, of course, helpful to the prosecutor but it must be remembered that the cases are not definitive in outlining the constituent elements of Section 341 and should be carefully scrutinized in terms of their particular fact situations. Keeping in view these limitations my proposal is to illustrate by current examples the type of conduct Section 341 is meant to prevent, to discuss some of the reported cases of

1. The present Section 341 appears as Section 326 (Criminal Code 1955) Section 231 (Criminal Code 1927, 1906) Section 201 (Criminal Code 1892).
2. R. v. Dowd (1899), 4 C.C.C. 170.
R. v. Harkness (1904), 10 C.C.C. 193.
Mount v. R. (1931) 51 Que. K.B. 482.
R. v. Smart and Young et al. (1931) 55 C.C.C. 310.
R. v. Link & Green, 111 C.C.C. 225.

prosecutions under the Section and then to examine the efficacy of Section 341 with respect to trading in commodity futures contracts, conventional options and naked options.

Commodity Futures Contracts

(a) "Gaming in stocks or merchandise"

Section 341 of the Criminal Code in its present form reads as follows:

(1) Every one is guilty of an indictable offence and is liable to imprisonment for five years who, with intent to make gain or profit by the rise or fall in price of the stock of an incorporated or unincorporated company or undertaking, whether in or out of Canada, or of any goods, wares or merchandise,

(a) makes or signs, or authorizes to be made or signed, any contract or agreement, oral or written, purporting to be for the purchase or sale of shares of stock or goods, wares or merchandise, without the bona fide intention of acquiring the shares, goods, wares or merchandise or of selling them, as the case may be; or

(b) makes or signs, or authorizes to be made or signed, any contract or agreement, oral or written, purporting to be for the sale or purchase of shares of stock or goods, wares or merchandise in respect of which no delivery of the thing sold or purchased is made or received, and without the bona fide intention of making or receiving delivery thereof, as the case may be;

but this section does not apply where a broker, on behalf of a purchaser, receives delivery, notwithstanding that the broker retains or pledges what is delivered as security for the advance of the purchase money or any part thereof.

(2) Where, in proceedings under this section, it is established that the accused made or signed a contract or agreement for the sale or purchase of shares of stock or goods, wares or merchandise, or acted, aided or abetted in the making or signing thereof, the burden of proof of a bona fide intention to acquire or to sell the shares, goods, wares or merchandise or to deliver or to receive delivery thereof, as the case may be, lies upon the accused.

The Section appears at first to have been enacted^{3/} to suppress gambling on the rise and fall of stock and commodity prices in the so-called "bucket-shop" of that era. In R. v. Harkness^{4/} a bucket shop was defined as: "An establishment conducted nominally for the transaction of a stock exchange business or a business of a similar character but really for the registration of bets or wagers usually for small amounts on the rise or fall of the prices of stock or commodity nominally dealt in."

Subsequently, the applicability of Section 341 to transactions which in essence are bets as to the rise or fall of commodities under the guise of fictitious sales and purchases of the commodity was affirmed by the Supreme Court of Canada in Pearson v. Carpenter & Son.^{5/} In that case Pearson instructed Carpenter & Son, brokers in Toronto to buy wheat at a certain price but, in fact, the wheat was never bought nor was there any intention to buy it, although a confirmation of the purchase was sent out. Nesbitt, J. in speaking for a unanimous Court characterized the transaction as follows:

"...[they - Carpenter] were carrying on...what is popularly known as a bucket shop, pure and simple, that is to say there was an absolute unreality as to any transactions. They never placed or intended to place any order which was telegraphed to them but simply entered same upon the sheets and bet against it...it is to my mind clearly within Section 201 of the Criminal Code [now Section 341]."

^{6/}

3. First enacted 1888, 51 Vict. c. 42, An Act respecting Gaming in Stocks and Merchandise Preamble: "Whereas gaming and wagering on the rise and fall in value of stocks and merchandise are detrimental to commercial and public morality, and places affording facilities for such gaming and wagering, commonly called bucket-shops, are being established; and it is expedient to prevent such gaming and wagering to punish the persons engaged in them, and to prohibit and punish the opening and maintaining of places therefor, and the frequenting thereof."

4. (1904) 10 C.C.C. 193. Affirmed: 10 C.C.C. 199 (Ont. C.A.).
5. (1904) 35 S.C.R. 380.
6. 35 S.C.R. at p. 382.

Some seventy years later, an example of striking factual similarity to the "bucket-shop" type of operation found to be illegal under Section 341 in Pearson v. Carpenter^{7/} by the Supreme Court of Canada can be found in the case of Regina v. John Vance.^{8/} It is my contention that the operation conducted by Vance is precisely the type of activity that Section 341 was designed to outlaw and it may therefore be instructive to set out the facts at some length:

In 1972 John Vance incorporated an Ontario Limited Company called Counterpoint Commodity Forecaster Inc. It appears that Vance's initial intention was to contact persons interested in investing in the commodity futures markets and have them place their orders through him. He, in turn, would place the orders with a registered broker holding a seat on a recognized commodity exchange. Although this was apparently his original intention, he ended up operating his company in an entirely different manner.

Rather than placing the orders with a broker, Vance merely "booked" these orders at his office, and none of the orders to buy or sell futures contracts of commodities were ever placed through a recognized commodity exchange.

After receiving a call from a customer, Vance or an employee, would quote the customer the current trading price on any commodity they were interested in. If the customer placed an order to either "buy" or "sell" a contract or contracts of a commodity, Vance would advise that they would try to do so and would call back. Later the same day, they would phone back and advise that they had "bought" or "sold" for the customer the required number of contracts of the commodity. On all "buy" orders, a "margin" was required and after confirming a "buy" the customer would be requested to forward a cheque to cover the "margin requirement".

The same day a confirmation notice was sent to the customer on Counterpoint Commodity Forecaster Inc. stationery, indicating the number of contracts bought, or sold, the type of commodity, the price per unit, and the Commodity Exchange that the transaction occurred on. Later, customer account statements were sent to the customers showing the recapitulation of trades and the debit or credit balance in his/her account.

All monies received from customers were placed in Counterpoint Commodity Forecaster Inc. bank account. As no orders were actually placed with registered brokers and/or a recognized commodity exchange, no monies were forwarded to either.

Instead Vance used the funds to pay his office staff, pay his

7. (1904) 35 S.C.R. 380.

8. Conviction registered by His Honour Judge Honsberger at Toronto County Court on September 10, 1974.

own salary, pay personal expenses, make investments of his own and also to pay off any customers who closed their accounts and wanted to withdraw funds.

Vance operated in this manner from 1 Dec. 72 until 20 June 73. As long as he was able to find new customers to invest and as long as his inflow of money was greater than the amount customers wished to withdraw, he was able to continue in business. However, in the spring of 1973, most of his customers invested in "Gold Futures Contracts" and the price of gold rose very rapidly at that time. The customers feeling they had made high profits began to "sell" off their gold contracts rapidly and began to demand their money from Vance. He was unable to pay, as his scheme was predicated on the hope that most customers would lose money, not make a profit. When pressured by customers for cheques to cover their profit, Vance issued several cheques which when presented to his bank were returned N.S.F.

It was not until this time that customers began to check on Vance and Counterpoint Commodity Forecaster Inc. They learned that he did not hold a seat on the Winnipeg Grain Exchange (the one commodity exchange in North America which dealt in Gold Futures) and eventually learned that their orders had not been placed with registered Brokers either.

There can be no question, in my view, that the facts as outlined would have supported a conviction under Section 341 of the Criminal Code. It is therefore somewhat suprising that Vance was charged and convicted of the offence of fraud under Section 338 of the Criminal Code.

Section 338(1) reads as follows:

(1) Every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this Act, defrauds the public or any person, whether ascertained or not, of any property, money or valuable security is guilty of an indictable offence and is liable to imprisonment for ten years.

The theory of the Crown in the Vance case was that Vance had represented to his clients that their orders for commodity futures contracts would be placed on a recognized commodity exchange. The clients in turn were prepared to testify that it was predominantly this representation by Vance which induced them to entrust their money to him. When in fact no orders were placed on the exchanges it was the contention of the Crown that the offence had been made out. Apart from the fact that a conviction for fraud carries a maximum penalty of ten years as opposed to five years for an offence against 341, the main advantage to proceeding

under the fraud section appears to be the comparative ease with which the offence can be proved.

It should be noted that it is quite possible to proceed with an indictment containing a count alleging fraud under Section 338 and a count alleging gaming in commodities under Section 341 in respect of the same transaction. In the cases of R. v. Smart and Young, R. v. Paterson and Campbell and R. v. Stobie and Forlong^{9/} the Court of Appeal for Ontario affirmed convictions under both 341 and 338(b). On the authority of the Supreme Court of Canada in Regina v. Kienapple^{10/} it will continue to be possible to have an indictment alleging separate offences emanating from the same transaction, but the Crown will be estopped from securing more than one conviction on the basis of the doctrine of res judicata. Apart from this rather technical consideration the short point is that depending on the fact situation there are other sections besides 341 of the Criminal Code that can be utilized to prosecute the classical "bucket-shop" operation.

For example, in R. v. Mount^{11/} a broker accepted orders from his clients for the purchase of stock, and, pretending to carry out the orders, accepted the purchase price with interest. The broker thereupon converted the money to his own use. Under these circumstances the Quebec Court of Appeal held that the broker was guilty both of theft and an offence under Section 341.

It should also be pointed out that under the Criminal Code of 1927, Section 232 provided that an office wherein transactions contrary to Section 231 (now 341) was a common gaming house.

In terms, Section 232 provided that:

9. (1931) 55 C.C.C. 310.

10. (1974) 26 C.R.N.S. 1 (S.C.C.).

11. (1931) 51 Que. K.B. 482.

Every office or place of business wherein is carried on the business of making or signing, or procuring to be made or signed, or negotiating or bargaining for the making or signing of contracts of sale or purchase prohibited by the last preceding section is a common gaming-house, and every one who as principal or agent occupies, uses, manages or maintains the same is the keeper of a common gaming-house. ^{12/}

Section 232 has been repealed, but it is my submission that the general gaming sections of the current Criminal Code, namely Sections 185 and 186 prohibiting the keeping of a common betting or gaming house and prohibiting bookmaking respectively, can also be utilized in most situations where Section 341 of the Code is applicable. It may well be, as has been suggested by some, that only Sections 185 and 186 are available where there is a clear intention on the part of both ^{13/} parties to "bet" on the basis of fluctuating prices of commodities in a situation where no contract for the purchase or sale of commodities is entered into.

Section 179 of the Criminal Code states that:

179. (1) In this Part

"bet" means a bet that is placed on any contingency or event that is to take place in or out of Canada, and without restricting the generality of the foregoing, includes a bet that is placed on any contingency relating to a horse-race, fight, match or sporting event that is to take place in or out of Canada;...

"common betting house" means a place that is opened, kept or used for the purpose of

(a) enabling, encouraging or assisting persons who resort thereto to bet between themselves or with the keeper, or

(b) enabling any person to receive, record, register, transmit or pay bets or to announce

12. Criminal Code 1927 repealed 1955.

13. It is clear that a "bet" for the purposes of the Criminal Code is not limited to the wagering contract at common law necessitating a mutual agreement on the part of both parties to the contract.

See: R. v. Benwell, Jarman et al. (1972), 9 C.C.C. (2d) 158 (Ont. C.A.)

Affirmed: 10 C.C.C. (2d) 503 (S.C.C.).

the results of betting;

"common gaming house" means a place that is

(a) kept for gain to which persons resort for the purpose of playing games, or

(b) kept or used for the purpose of playing games

(i) in which a bank is kept by one or more but not all of the players,

(ii) in which all or any portion of bets on or proceeds from a game is paid, directly or indirectly, to the keeper of the place,

(iii) in which, directly or indirectly, a fee is charged to or paid by the players for the privilege of playing or participating in a game or using gaming equipment, or

(iv) in which the chances of winning are not equally favourable to all persons who play the game, including the person, if any, who conducts the game;

...

"game" means a game of chance or mixed chance and skill;

"gaming equipment" means anything that is or may be used for the purpose of playing games or for betting;

"keeper" includes a person who

(a) is an owner or occupier of a place,

(b) assists or acts on behalf of an owner or occupier of a place,

(c) appears to be, or to assist or act on behalf of an owner or occupier of a place,

(d) has the care or management of a place, or

(e) uses a place permanently or temporarily, with or without the consent of the owner or occupier;

"place" includes any place, whether or not

(a) it is covered or enclosed,

(b) it is used permanently or temporarily, or

(c) any person has an exclusive right of user with respect to it.

...

(2) A place is not a common gaming house within the meaning of paragraph (a) or subparagraph (b)(ii) or (iii) of the definition "common gaming house" in subsection (1) while it is occupied and used by an incor-

porated bona fide social club or branch thereof, if

(a) the whole or any portion of the bets on or proceeds from games played therein is not directly or indirectly paid to the keeper thereof, and

(b) no fee is charged to persons for the right or privilege of participating in the games played therein other than under the authority of and in accordance with the terms of a licence issued by the Attorney General of the province in which the place is situated or by such other person or authority in the province as may be specified by the Attorney General thereof.

(3) The onus of proving that, by virtue of subsection (2), a place is not a common gaming house is on the accused.

(4) A place may be a common gaming house notwithstanding that

(a) it is used for the purpose of playing part of a game and another part of the game is played elsewhere; or

(b) the stake that is played for is in some other place

Section 185 of the Criminal Code states that:

185(1) Every one who keeps a common gaming house or common betting house is guilty of an indictable offence and is liable to imprisonment for two years.

(2) Every one who

(a) is found, without lawful excuse, in a common gaming house or common betting house, or

(b) as owner, landlord, lessor, tenant, occupier or agent, knowingly permits a place to be let or used for the purposes of a common gaming house or common betting house,

is guilty of an offence punishable on summary conviction.

Section 186 of the Criminal Code states that:

186.(1) Every one commits an offence who

(a) uses or knowingly allows a place under his control to be used for the purpose of recording or registering bets or selling a pool;...

(c) has under his control any money or other property relating to a transaction that is an offence under this section;

(d) records or registers bets or sells a pool;

(e) engages in pool-selling or book-making, or in the business or occupation of betting, or makes any agreement for the purchase or sale of betting or gaming privileges, or for the purchase or sale of information that is intended to assist in book-making, pool-selling or betting;...

(2) Every one who commits an offence under this section is guilty of an indictable offence and is liable to imprisonment for two years.

To complete this segment of the discussion, reference should also be made to the situation where a broker in Ontario enters into a transaction with a client in Ontario on behalf of a principal located in a foreign country. This, of course, is an important consideration in view of the fact that the Winnipeg Commodity Exchange appears to be the only Canadian commodity exchange and because a great deal of trading by Canadians is done with American and other foreign commodity exchanges.

In R. v. Harkness,^{14/} the Court of Appeal for Ontario held that a broker who maintained an office in Canada where fictitious transactions were entered into with his principal in the United States, and, if he knew the transactions were fictitious, was guilty of an offence under Section 341 in that he aided and abetted the commission of the offence by virtue of Section 21 of the Criminal Code. In Pearson v. Carpenter^{15/} a Canadian broker accepted orders in Canada and transmitted these to his principals in the United States and a confirmation was received from the United States firm. The Supreme Court of Canada held that the contract was consummated in Canada and illegal under Section 341 if it encompassed a betting transaction. In Regina v. Dowd^{16/} the accused broker accepted orders from Canadian clients on behalf of his principal, an American Com-

14. (1904) 10 C.C.C. 193. Affirmed: 10 C.C.C. 199.

15. (1904) 35 S.C.R. 380.

See also, R. v. Link and Green 111 C.C.C. 225;
Trench v. Brink (1910) 1 O.W.N. 789.

16. (1399) 4 C.C.C. 170.

pany. His Honour Judge Choquet held that Section 201 (now 341) requires three essential elements:

- (1) having an intent to make gain or profit;
- (2) making or signing contracts purporting to be for the sale or purchase of certain commodities; and
- (3) absence of bona fide intention to make or receive delivery.

Since the broker was merely acting as an agent for the two parties, one a buyer and the other a seller, without having any pecuniary interest in the transaction beyond his fixed commission, ^{17/} and, without any guilty knowledge on his part of the intention of the contracting parties to gamble in stocks or merchandise a conviction under either Section 341(1) of the Code or as a party under Section 21 of the Code was unavailable.

(b) "The Bona Fide Intention of Making or Receiving Delivery"

It will be seen at a glance that the distinguishing feature of contracts illegal, first, under Section 341(1) (a) is that they are made without a bona fide intention of acquiring the commodity and secondly, under Section 341(1) (b) is that they are made without a bona fide intention of making or receiving delivery. In Section 341(2) Parliament has seen fit to enact a reverse-onus clause so that if the prosecutor can prove that an accused has made a contract for the sale or purchase of a commodity it will then be up to the accused to prove on a balance of probabilities that he had a bona fide intention to either acquire the commodity or to make or receive delivery of the commodity. It is therefore evident that it is of vital interest to both the prosecutor and the accused to understand what will constitute a "bona fide intention" in a given fact situation.

The most important and interesting problem is that posed by

17. See also: Bernstein v. Shapiro (1916) 26 D.L.R. 406;
Stevenson v. Brais (1897) 7 Que. Q.B. 77 (C.A.);
Forget v. Ostigny, [1895] A.C. 318.

the trade of commodity futures contracts on commodity exchanges where at the present time 97% of all contractual obligations are set-off by the operation of a clearing house and only 3% of the commodities purchased and sold through commodity futures contracts are actually delivered. There have been three Supreme Court of Canada decisions^{18/} in civil actions which have canvassed the applicability of Section 341 to commodity futures contracts executed on commodity exchanges.

Insofar as the commodity futures contracts must be made with the bona fide intention to make or receive delivery the learned author of Tremeeear's Annotated Criminal Code asserts:

"In the Prudential Exchange case, it seems to be definitely settled that it is not necessary that the parties should have in contemplation actual delivery in specie of the commodity question, provided that real transactions are entered into, and a binding obligation created for delivery by some person, not necessarily the customer, and for payment by some other person."^{19/}

Duff, C.J.C. in the Prudential Exchange case while discussing the machinery of the exchange in setting-off contractual obligations said at p. 142:

"Nor do I think the statute applies, to put the case in its simplest form where the transaction contemplates delivery and payment and the enforceability of the obligations to deliver and pay, merely because one of the parties intends to make use of the machinery of an exchange in such a way as to discharge his obligation to deliver by the acquisition of a converse obligation to deliver to him and the setting off of these obligations one against the other; provided always that the converse obligation is equally real and equally enforceable in point of law."

Finally at page 154 of the same Judgment, Davis, J. said:

18. Beamish v. James Richardson & Sons Ltd. (1914), 49 S.C.R. 595; Maloof v. Bickell & Co. (1920) 59 S.C.R. 429; Prudential Exchange Co. v. Edwards, [1939] S.C.R. 135.

See also footnote 21.

19. Sixth Edition at p. 546.

"In one sense it is true, in most marginal trading on a stock market, that the customer does not expect to be called upon to make physical delivery of share certificates representing the shares that he has sold or to take physical delivery and make payment in full for the shares which he has bought. When a marginal trader sells either short or long he probably seldom visualizes the obligation to take or to give delivery - he is so hopeful of a rising or a falling market in the particular stock or commodity in which he is trading that he expects within a short time to be able to close his account and take out a money profit. But the legal obligation is always there and he knows perfectly well that it is there. If a customer who deals on a recognized stock exchange could, every time he loses heavily by the stock going the opposite way from that which he expected, turn round and say that he never intended to have any real transactions in the stock or commodities but was merely gambling in breach of the Criminal Code, it would be quite impossible to carry on the business of a well regulated public stock exchange which renders its own peculiar public service. Here, the Respondent admits that he wanted real sales to be made and real purchases to be made for him on the Winnipeg Grain Exchange for future delivery. I cannot see that he can escape from the payment of his losses."

It is my respectful submission, that with respect to the trade in commodity futures contracts on commodity exchanges the Supreme Court of Canada has interpreted the requirement of Section 341 that contracts for commodities be made with the bona fide intention to make or receive delivery to mean that contracts for commodities are to encompass real, legally binding obligations for the making or receiving of delivery. Therefore, an accused will apparently discharge the onus of proof under 341(2) by demonstrating that he has entered into a contract with real, binding obligations to make or receive delivery without necessarily making or receiving delivery. Of course, evidence that actual delivery has been effected will ^{20/} always discharge the burden of proof.

20. Stevenson v. Brals (1897), 7 Que. Q.B. 77 (C.A.);
Smith Grain Co. v. Pound, [1917] 36 D.L.R. 615;
Heintz v. Collier (1908), 12 O.W.R. 681
Affirmed 13 O.W.R. 824 (C.A.);
Stack v. Somerville (1917), 40 D.L.R. 374
Affirmed 41 D.L.R. 591;
Woodward & Co. v. Koefoed 37 C.C.C. 329;
Beyea v. Johnston & Ward, [1930] 4 D.L.R. 421 (N.B.C.A.).

It is of course still open for a future judgment of the Supreme Court of Canada to distinguish the Prudential Exchange case on the basis of the fact that in the Prudential Exchange case there was no evidence that the obligations were set-off by a clearing house.^{21/}

Putting the argument in its extreme form, it is submitted that the Supreme Court of Canada has never considered the question of whether trading in commodity futures contracts offends against Section 341 in circumstances where evidence was adduced that the intention of the parties was solely to use the clearing house operation of the exchange to offset the contracts with absolutely no intent to actually take delivery, notwithstanding that real, legally binding obligations to make or take delivery are encompassed in the contract itself.

However, even if the law is not completely settled it is noteworthy that since the Prudential Exchange decision there does not appear to be a single reported civil case in which a defence based on an illegal contract within Section 341 has been advanced nor for that matter has there ever been a prosecution under the circumstances outlined by any of the cases in the Supreme Court of Canada.

Conventional Options

The conventional option in commodity futures contracts is an option to purchase from or sell to the grantor of the option an underlying commodity futures contract at a fixed price. An option is therefore an

21. Mr. Keith E. Boast, Study Director, Inter-Ministerial Commodity Futures Study Committee, has very thoroughly analyzed the three Supreme Court of Canada judgments, contained in footnote 18, wherein the Supreme Court, in civil appeals, considered the legality of commodity futures contracts properly executed on recognized commodity exchanges. He concluded that Section 341 as presently drafted cast a shadow over such transactions. The Deputy Attorney General is considering the significance of the judgments of the Supreme Court of Canada with a view to making a recommendation to the Federal Government or, alternatively, to raising the matter at the annual Uniformity Conference of Attorneys General at which time an amendment could be considered by all provincial Attorneys General as well as the Minister of Justice.

agreement or contract to purchase another contract, viz., a commodity futures contract. Insofar as Section 341 of the Criminal Code deals with contracts for the purchase of "goods", it would appear, prima facie that an option is not within Section 341 unless the term "goods" can be defined as a commodity futures contract.

Section 337 of the Criminal Code states:

337. In this Part
"goods" means anything the subject of
trade and commerce.

Assuming that a commodity futures contract is the subject of trade and commerce, it follows therefore that a contract for the purchase of commodity futures contract is a contract for the purchase of goods within Section 341 of the Criminal Code.

Whether or not commodity options are caught by Section 341 will depend on whether or not a particular accused can demonstrate in accordance with Section 341(2) that he has a bona fide intention to make or take delivery of the underlying commodity futures contract. Using the reasoning of the Prudential Exchange case the test would be whether or not there were legal binding obligations upon exercise of the option for the grantor to deliver the underlying commodity futures contract and for the grantee to accept delivery of the contract.

The English Court of Appeal in the case of Buitelandsche Bankvereeniging v. Hildesheim^{22/} held that an option contract to purchase a right to call for shares on a certain date was not per se a gaming and wagering contract. In that case the plaintiff was ready, willing and able to deliver the shares if the defendant had asked for them, and, indeed, the plaintiff had secured the shares from a third party. The plaintiff sued the defendant to recover the consideration for the option and the defendant set up a defence that option was a gaming and wagering contract. The Master

22. (1903) 19 T.L.R. 641 (C.A.).

of the Rolls held that:

"It was not a bet, nor was it a gaming contract. The consideration was paid for a real right to call for particular shares on a given date... [but] if upon the evidence the true inference from all the facts was that, though the contract was in form a contract which gave the right to call for the shares nevertheless the parties never intended that the contract should be enforced, and there was a tacit understanding that it should not be enforced, but that differences only should be paid, the case would be different."^{23/}

It should, therefore, not be assumed that it is the form of the contract which will determine the applicability of Section 341 to transactions in both commodity futures contracts and in options on commodity futures contracts but rather the real intention^{24/} of the parties. In the leading case of Universal Stock Exchange v. Strachan^{25/} the House of Lords held that where the real intent of parties is merely to settle differences instead of an intent to actually deliver shares the contract is illegal as a gaming contract and is not made legal by the fact that the contract provides that delivery may be required by either party. It is, therefore, submitted that with regard to Section 341, a contract which provides for the making or receiving of delivery will certainly be strong evidence to dispel the burden placed on an accused under Section 341(2) to demonstrate a bona fide intent to deliver. However, the mere existence of such a contract is not determinative of the issue because what is paramount is the real intention of the parties to make or receive delivery and this determination will be based on all the evidence.

Naked Options

The "naked" option, as distinct from the conventional option

23. (1903) 19 T.L.R. at 641 and 642.

24. In re Gieve, [1899] 1 Q.B. 794 (C.A.).

25. [1896] A.C. 166.

discussed above, has been described as representing nothing more than the option grantor's unsupported promise to perform because the naked option grantor does not own the underlying futures contract or the physical commodity to meet his obligations under the contract.

It is at once evident, that the naked option grantor will have an exceedingly difficult task in discharging the burden of proof required under Section 341(2) of the Criminal Code. One is hardpressed to understand how it can be successfully claimed that there is a bona fide intention to make or take delivery of the underlying commodity futures contract when the option grantor does not own the underlying contract or the physical commodity or, indeed, as is often the case, does not have the capital to acquire the contract or the commodity. Moreover, to the extent that the naked option includes a term which would enable the grantor to buy back the option crediting the customer with the difference between "striking price" and the current price of an imaginary commodity futures contract, the naked option contract would appear to be precisely the type of gaming and wagering contract found illegal by the House of Lords in Universal Stock Exchange Ltd. v. Strachan.^{26/} Therefore, it would appear to be a relatively simple evidentiary task to demonstrate a lack of bona fide intention to make or take delivery.

The case of Regina v. Thomas Boyle^{27/} is illustrative of a "naked" option grantor who operated a "bucket-shop" operation in options. This case is significant also because it lends perspective to the applicability of various sections of the Criminal Code. This in turn depends

26. [1896] A.C. 166.

27. Convicted of Fraud by His Honour Judge Rice, at Toronto, Provincial Court, on September 20, 1974.

largely upon the nature of the representations made by the option grantor to his customers. In the Boyle case the facts were that the options sold were those of a firm called Crown Associates. Boyle, who was a partner in this firm represented to customers that these options were to be or in fact were secured by commodity futures contracts purchased on the Winnipeg Commodity Exchange, the Chicago Board of Trade and other recognized commodity exchanges. In fact no commodity futures contracts were procured nor were there funds available for this purpose. The options were merely booked in the office of the company. If a customer decided to exercise his option the company would merely pay the difference between the "striking price" and the price of the commodity futures contract as of the day of exercise. The money to pay successful customers would be obtained directly from the premiums paid by other customers for their options. Also, the company encouraged successful customers to re-invest in further options with the hope that eventually the customers would lose their investment by mistaking the direction of the market.

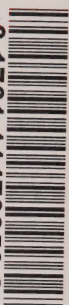
It should be noted that the representation made by Boyle to the customers of Crown Associates was that Crown Associates would purchase or had purchased commodity futures contracts on recognized commodity exchanges. Moreover, the customers of Crown Associates were prepared to testify that it was this false misrepresentation which induced them to deal with Crown Associates. In view of the fraudulent misrepresentation Boyle was charged and upon a plea of guilty was convicted of fraud under Section 338 of the Code.

But, what of the applicability of Section 341? There is very little doubt that the evidence could not support a bona fide intention to make or receive delivery of the underlying futures contract so that Section 341 would be applicable unless the contract that had been entered into was not for "goods, wares and merchandise". Boyle represented to customers that they were purchasing an option to purchase or sell commodity futures

contracts on a recognized exchange and the customers certainly believed that this indeed was the contract they were entering into. If the transaction is to be characterized in terms of the representations made by customers to Boyle on behalf of Crown Associates, then Section 341 is applicable in precisely the same way as it is to convention option contracts, namely, by virtue of the wide definition of goods in Section 337 of the Criminal Code which encompasses "anything the subject of trade and commerce".

Conclusion

This survey of the applicability of Section 341 to some of the present practices of trading in commodities futures contracts as well as options to purchase such contracts does not pretend to be exhaustive. In any event criminal sanctions are at best an ex post facto remedy and of little consolation to members of the public who have been defrauded. If this paper has served to point out the need for provincial regulation geared at the prevention of the abuses in the trading of commodity futures contracts which the cases illustrate it will have served its purpose.



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